87-1578

No. 87-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—v.—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *et al.*,

Respondents.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 1488, 1489, 1490, 1491, 1492,
1493, 1494—August Term 1986

(Argued June 23, 1987 Decided February 8, 1988)

Docket Nos. 87-4041, 87-4055, 87-4057, 87-4059,
87-4061, 87-4063, 87-4067, 87-4069, 87-4071, 87-4073,
87-4075, 87-4077, 87-4079, 87-4085

SECURITIES INDUSTRY ASSOCIATION,

Petitioner-Cross-Respondent,

—v.—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, PAUL A. VOLCKER, as Chairman of the Board of Governors of the Federal Reserve System, MANUEL H. JOHNSON, WAYNE D. ANGELL, ROBERT H. HELLER, and MARTHA R. SEGER, as members of the Board of Governors of the Federal Reserve System,

Respondents,

BANKERS TRUST NEW YORK CORPORATION, J.P. MORGAN & CO. INCORPORATED, and CITICORP and THE CHASE MANHATTAN CORPORATION, MANUFACTURERS HANOVER CORPORATION, and CHEMICAL NEW YORK CORP., SECURITY PACIFIC CORPORATION,

Intervenors-Respondents Cross-Petitioners.

B e f o r e :

CARDAMONE, PIERCE and WINTER,
Circuit Judges.

The Securities Industry Association petitions for review of six orders of the Board of Governors of the Federal Reserve System. The Board found that bank holding company subsidiaries already engaged entirely in underwriting and dealing in federal, state, and local government securities could underwrite and deal in, to a limited extent, municipal revenue bonds, mortgage related securities, and commercial paper without contravening § 20 of the Glass-Steagall Act. Bankers Trust New York Corp., J.P. Morgan & Co., Inc., Citicorp, The Chase Manhattan Corp., Manufacturers Hanover Corp., Chemical New York Corp. and Security Pacific Corp. cross-petition for review of the Board's limitations on the securities activities of their subsidiaries.

Petitions for review denied.

Cross-petition for review denied in part and granted in part.

JAMES B. WEIDNER, New York, New York (David A. Schulz, Mark Holland, Peter Kimm, Jr., Roger & Wells, New York, New York; William J. Fitzpatrick, New York, New York; Donald J. Crawford, Washington, D.C., of counsel), *for Petitioner-Cross-Respondent Securities Industry Association.*

MICHAEL S. HELFER, Washington, D.C. (Christopher Lipsett, Thomas P. Olson, Wilmer, Cutler & Pickering, Washington, D.C., of counsel), *Pro Hac Vice for Intervenor-Respondent Cross-Petitioner Citibank.*

LEWIS B. KADEN, New York, New York (Lowell Gordon Harriss, D. Scott Wise, Davis Polk & Wardwell, New York, New York, of counsel), *for Intervenor-Respondent Cross-Petitioner J.P. Morgan & Co. Incorporated.*

RICHARD M. ASHTON, Washington, D.C., (Richard K. Willard, Assistant Attorney General, U.S. Department of Justice, Michael Bradfield, General Counsel, Kay E. Bondehagen, Douglas B. Jordan, Washington, D.C.; Robert M. Kimmitt, Department of the Treasury; Richard V. Fitzgerald, Office of the Comptroller of the Currency, Washington, D.C., of counsel), *for Respondents Board of Governors of the Federal Reserve System, et al.*

DAVIS POLK & WARDWELL, New York, New York, attorneys for J.P. Morgan & Co., Incorporated; White & Case, New York, New York, attorneys for Bankers Trust New York Corporation; Shearman & Sterling, New York, New York and Wilmer, Cutler & Pickering, Washington, D.C., attorneys for Citicorp; Cravath, Swaine & Moore, New York, New York,

attorneys for Chemical New York Corporation; Milbank, Tweed, Hadley & McCloy, New York, New York, attorneys for The Chase Manhattan Corporation; Simpson Thacher & Bartlett, New York, New York, attorneys for Manufacturers Hanover Corporation; O'Melveny & Myers, New York, New York, attorneys for Security Pacific Corporation; all of counsel), *filed a brief on behalf of Intervenors-Respondents Cross-Petitioners.*

MARTIN GLENN, O'Melveny & Myers, New York, New York (Russell A. Freeman, Dan C. Aardal, Security Pacific Corporation, Los Angeles, California; Edward J. McAniff, Michael J. Fairclough, O'Melveny & Myers, Los Angeles, California; William T. Coleman, Jr., John H. Beisner, Jacob M. Lewis, James P. Nehf, O'Melveny & Myers, Washington, D.C., of counsel), *filed a brief on behalf of Intervenor-Respondent, Cross-Petitioner Security Pacific Corporation.*

DAVID M. MILES, Washington, D.C. (Harvey L. Pitt, Henry A. Hubschman, Fried, Frank, Harris, Shriver & Jacobson, Washington, D.C.; Matthew P. Fink, Senior Vice President and General Counsel, Sarah O'Neil, Associate General Counsel, Investment Company Institute, Washington, D.C., of counsel), *filed a*

brief on behalf of Investment Company Institute as Amicus Curiae.

HOGAN & HARTSON, Washington, D.C. (Neal L. Petersen, Keith R. Fisher, James G. Christiansen, Washington, D.C., of counsel), *filed a brief on behalf of Bank Capital Markets Association as Amicus Curiae.*

JOHN J. GILL, General Counsel, Washington, D.C. (Michael F. Crotty, Associate General Counsel-Litigation, American Bankers Association, Washington, D.C., of counsel), *filed a brief on behalf of the American Bankers Association as Amicus Curiae.*

CARDAMONE, *Circuit Judge*:

We review on this appeal those provisions of the Banking Act of 1933 that separated the commercial and investment banking industries and are known as the Glass-Steagall Act. *See* Pub. L. No. 73-66, §§ 16, 20, 21, & 32, 48 Stat. 162 (1933). Demand for divorcing banking and securities activities followed in the wake of the stock market crash of 1929, which occurred, it was said, because a mountain of credit rested on only a molehill of cash. The actions of the Federal Reserve Board that we review today allow commercial and investment banking to compete in a narrow market, and to that extent dismantle the wall of separation installed between them by the Glass-Steagall Act. Whether Santayana's notion

that those who will not learn from the past are condemned to repeat it fairly characterizes the consequences of the Board's action is not for us to say. Our task is to review the Glass-Steagall Act, the legislative history that surrounded its enactment, and its prior judicial construction to determine whether the Board reasonably interpreted the Act's often ambiguous terms.

The Securities Industry Association (SIA) and seven bank holding companies petition for review of six related orders of the Board of Governors of the Federal Reserve System (Board). The orders approved the bank holding companies' applications to utilize subsidiaries as the vehicle by which they can underwrite and deal in certain securities. The Board determined that the approved activities would not run afoul of § 20 of the Glass-Steagall Act, which proscribes affiliations of banks—here, the holding companies' member bank subsidiaries—with entities that are "engaged principally" in underwriting and dealing in securities. At the same time, the Board limited the scope of the approved activities. The decisions allowing bank subsidiaries to engage in securities transactions and the limitations that were imposed are the focus of the petitions seeking review. For the reasons set forth below, we deny the petitions for review save for the bank holding companies' cross-petition for review that seeks to eliminate the market share limitation.

BACKGROUND

I *The Board's Orders*

On April 30, 1987 the Board approved the applications of Citicorp, J.P. Morgan & Co., Inc., and Bankers Trust New York Corp. to engage in limited securities activities through wholly-owned subsidiaries. 73 Fed. Reserve Bull.

473 (1987). At the time of the applications, the subsidiaries were engaged entirely in underwriting and dealing in U.S. government and agency securities and those of state and municipal governments. The holding companies sought to extend their subsidiaries' activities to underwriting and dealing in municipal revenue bonds, mortgage related securities, consumer receivables related securities, and commercial paper.[1] With the exception of the consumer receivables, on which decision was deferred because of an insufficient record, the Board approved the applications by a vote of three to two. Limitations on the scope of the activities more restrictive than those initially proposed by the holding companies—to be discussed more fully below—were imposed.

On May 18, 1987 the Board approved the applications of four other bank holding companies, Chase Manhattan Corp., Chemical New York Corp., Manufacturers Hanover Corp., and Security Pacific Corp., to underwrite and deal in the same activities to the same extent approved in its April 30th order. 73 Fed. Reserve Bull. 607 (1987); *id.* at 616; *id.* at 620; *id.* at 622. With the exception of Chase Manhattan, each holding company then had an existing subsidiary currently engaged in underwriting and dealing in federal, state, and local government securities. Chase Manhattan's application included a request for its subsidiary to engage in government securities activities, which the Board approved. The Board also approved Citicorp's supplemental application to deal in commercial paper. *Id.* at 618.

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1 J.P. Morgan & Co. did not apply to underwrite or deal in consumer receivables related securities and Citicorp did not propose to engage in activities relating to commercial paper.

SIA, a trade association representing securities brokers, dealers, and underwriters, petitioned for review of the April 30th and May 18th orders, arguing that the approved activities would violate § 20 of the Glass-Steagall Act. The holding companies cross-petitioned challenging the Board imposed limitations. We granted a stay of the orders on May 19, 1987 pending this expedited appeal.

II *The Board's Analysis*

The bank holding companies' applications were made pursuant to § 4(c)(8) of the Bank Holding Company Act of 1956, which allows a bank holding company to acquire the "shares of any company the activities of which the Board . . . has determined . . . to be so closely related to banking . . . as to be a proper incident thereto." 12 U.S.C. § 1843(c)(8) (1982). The determination that the approved securities activities are closely related to banking is not contested on this appeal. Rather, since the Board's discretion under § 4(c)(8) is limited by the Glass-Steagall Act, *cf. Board of Governors of Fed. Reserve Sys. v. Investment Co. Inst.*, 450 U.S. 46, 76-77 (1981) (*ICI*), the principal issue before the Board was whether the approval of the activities would contravene that Act.

Section 20 of the Glass-Steagall Act forbids a member bank of the Federal Reserve System from affiliating with an organization "engaged principally" in, *inter alia*, underwriting or dealing in securities. 12 U.S.C. § 377 (1982). Bank holding companies have been allowed since 1978—without a court challenge by SIA—to acquire or form subsidiaries that underwrite and deal in securities representing obligations of the United States and of states and their political subdivisions. *See, e.g., United Bancorp*, 64 Fed. Reserve Bull. 222 (1978); *see also* 12 C.F.R.

§ 225.25(b)(16) (1987) (regulation permitting such activity). Section 16 of the Glass-Steagall Act expressly permits banks themselves to underwrite and deal in these governmental securities, known as "bank-eligible securities." 12 U.S.C. § 24 (Seventh) (1982 & Supp. IV 1986).

Given the authorization in § 16 for banks to engage in bank-eligible securities activities, the Board concluded that Congress did not aim in § 20 to proscribe bank affiliates from engaging in the same activities. 73 Fed. Reserve Bull. at 478-81. It reasoned that it would be anomalous not to permit the bank's subsidiary to engage in the activities lawfully permitted the bank. That illogical result necessarily follows if bank-eligible securities are defined as "securities" under § 20 because that section prohibits a member bank from being affiliated with an organization "engaged principally" in securities dealing. Hence, according to the Board, "securities" cannot logically mean bank-eligible securities. "Securities" in § 20 must therefore only refer to those types of securities that under § 16 banks cannot themselves deal in or underwrite, known as "bank-ineligible securities." The activities approved in the orders at issue on this appeal—underwriting and dealing in municipal revenue bonds, mortgage related securities, and commercial paper—cannot be conducted by a member bank and are therefore bank-ineligible securities activities.

Establishing as a predicate that the proscription in § 20 extends only to bank-ineligible securities, the Board turned to the question of when an affiliate is "engaged principally" in such activity. Relying on its order in *Bankers Trust New York Corp.*, 73 Fed. Reserve Bull. 138

(1987),[2] the Board held that the term "engaged principally" means any substantial activity. 73 Fed. Reserve Bull. at 482. It then concluded that subsidiaries would not be engaged substantially in bank-ineligible activities if no more than five to ten percent of their total gross revenues was derived from such activities over a two-year period, and if the activities in connection with *each* type of bank-ineligible security did not constitute more than five to ten percent of the market for that particular security. *Id.* at 485-86. The Board then proceeded to approve gross revenue and market share levels at five percent—the low end of the acceptable range—but stated that it would review the five percent limitations within a year after the implementation of its orders. The applicants wanted, of course, to engage in higher levels of activity.

On review, SIA argues that the Board erroneously construed the Glass-Steagall Act by construing the word "securities" in § 20 not to include bank-eligible securities. In other words, SIA contends that § 20 limits both bank-eligible *and* bank-ineligible security activities by a member bank affiliate. SIA also objects to the Board's construction of "engaged principally." The bank holding companies urge us to adopt the Board's construction of § 20 with regard to "securities", but argue, at the same time, that the Glass-Steagall Act mandates that the Board allow a higher level of bank-ineligible activity than that approved.

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2 Petitions for review of this order are pending in the United States Court of Appeals for the District of Columbia Circuit.

THRESHOLD MATTERS

I *The Moratorium*

Subsequent to the stay granted in this case, Congress enacted and the President signed into law on August 10, 1987 the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552 (CEBA),[3] the provisions of which impose a moratorium period, effective retroactively, prohibiting the Board from approving affiliate involvement in certain securities transactions. Section 201(b) provides that between March 6, 1987 and March 1, 1988,

> (2) A Federal banking agency may not authorize or allow by action, inaction, or otherwise any bank holding company or subsidiary or affiliate thereof . . . to engage in the United States to any extent whatever—
>
> (A) in the flotation, underwriting, public sale, dealing in, or distribution of securities if that approval would require the agency to determine that the entity which would conduct such activities would not be engaged principally in such activities . . . .

CEBA, § 201(b), 101 Stat. at 582 (to be codified at 12 U.S.C. § 1841 note).

Under § 202 the Board may issue an order during the moratorium period pursuant to its authority in existence before CEBA "if the effective date of such . . . order is delayed until the expiration of such moratorium." 101

3 In September the panel wrote to counsel requesting them to advise whether in light of CEBA this appeal remains viable. All counsel promptly responded by early October, 1987 that in their view the appeal was not mooted by the moratorium legislation.

Stat. at 584 (to be codified at 12 U.S.C. § 1841 note). According to the Joint Explanatory Statement of the Conference Committee to fall within this exception an order "must contain or otherwise be subject to" a specification "that the powers in question may not be exercised before the moratorium has expired." H.R. Conf. Rep. No. 261, 100th Cong., 1st Sess. 149 (1987), *reprinted in* 1987 U.S. Code Cong. & Admin. News 588, 618.

Each order subject to our review was issued during the moratorium period and each approved of activities covered by § 201. Nevertheless, the Board noted in its April 30th order that it was aware that Congress might impose the moratorium and that there might be an exception for orders that delay the effective date. 73 Fed. Reserve Bull. at 502. The Board then called to the applicants' attention that subsequent legislation might require them to cease the approved activities in the event of a moratorium and also retained jurisdiction "to act to carry out the requirements of any legislation adopted by Congress" that affected the activities approved under the order. *Id.* Identical explanations and caveats appear in the other orders relevant to this appeal. Thus, their effective date effectively was delayed in the event of a moratorium, as mandated by § 202. CEBA therefore in no way precludes our review of the substantive issues presented in these petitions. Before considering them, we discuss briefly the applicable standard of review.

II *Standard of Review*

The starting point for reviewing an agency's construction of a statute is the language of the statute. *See, e.g., Federal Deposit Ins. Corp. v. Philadelphia Gear Corp.*, 106 S. Ct. 1931, 1934 (1986); *Board of Governors of the*

Fed. Reserve Sys. v. Dimension Fin. Corp., 474 U.S. 361, 368 (1986); *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). An agency's construction of unambiguous statutory language is never an issue because the clear language of the statute must be given effect by the agency and the courts. *See Chevron*, 467 U.S. at 842-43 ("If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."). Only when the statutory language is ambiguous must a court inquire whether the agency's construction is permissible. *Id.* at 843. If the Board's interpretation of the Glass-Steagall Act is reasonable its decision must be upheld. *See Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 716 F.2d 92, 95 (2d Cir. 1983) ("Because the Board has both primary responsibility for implementing the Glass-Steagall Act and expert knowledge of commercial banking, we must uphold its interpretation of the Act if it is reasonable."), *aff'd*, 468 U.S. 207 (1984). Thus, the first question is whether § 20 is ambiguous.

The Board readily concedes that the term "securities" in § 20 could be read to include not only those securities that banks are expressly permitted to underwrite or deal in, that is, bank-eligible securities, but also those that banks are not entitled to underwrite or deal in, that is, bank-ineligible securities. Unlike § 16—which expressly distinguishes bank-eligible from bank-ineligible securities—§ 20 does not distinguish the terms. Hence, at least on the surface § 20 would appear to refer to both kinds of securities.

But a closer examination of Glass-Steagall leads us to reject this conclusion. In the first place, the Act makes

three different references to the term "securities." Section 16 distinguishes bank-eligible from bank-ineligible securities. 12 U.S.C. § 24 (Seventh) (1982 & Supp. IV 1986). Repealed § 19(e), discussed *infra* note 4, referred to "securities *of any sort*." 48 Stat. at 188 (emphasis added). And §§ 20 and 32 refer simply to "securities." 12 U.S.C. § 377 (1982) (§ 20); 48 Stat. at 194 (codified as amended at 12 U.S.C. § 78 (1982)) (§ 32). That Congress chose three distinctively different ways to describe securities raises a red flag that cautions against declaring that the meaning of that term in § 20 is clear.

Further support for the proposition that § 20 is uncertain is provided by the subsequent amendment to § 21 of Glass-Steagall. Section 21 originally did not expressly exempt bank-eligible securities as did § 16. A 1935 amendment made it plain that § 21 did not prevent that which § 16 permitted. *See* Banking Act of 1935, Pub. L. No. 74-305, § 303, 49 Stat. 684, 707. The significance of this to the issue of § 20's ambiguity is that the amendment was only intended to *clarify* existing law, *see, e.g.*, H.R. Rep. No. 742, 74th Cong., 1st Sess. 16 (1935); S. Rep. No. 1260, 73d Cong., 2d Sess. 2 (1934); *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 807 F.2d 1052, 1057-58 (D.C. Cir. 1986) (*Bankers Trust II*), *cert. denied*, 107 S. Ct. 3228 (1987), and did not purport to effect any substantive change. But, if the 1935 amendment was not intended to alter the substance of § 21, it follows that the Congress that enacted Glass-Steagall did not invariably make an explicit distinction between bank-eligible and bank-ineligible securities, even when it aimed to distinguish them from one another. Based on this, we can conclude with some confidence that Congress' reference in § 20 to "securities" is ambiguous,

and undertake to decide whether the Board's interpretation of securities in § 20 is reasonable and therefore entitled to deference.

Of course, "deference is not to be a device that emasculates the significance of judicial review." *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137, 142-43 (1984) (*Bankers Trust I*). One factor militating against deference to the Board's definition of securities is its failure to address an apparent contradiction, discussed below, between its interpretation of § 20 and its prior view of § 32. This failure implicates two factors that courts take into consideration in deciding whether to accord deference to an administrative agency charged with implementing a statute: first, "the thoroughness, validity, and consistency of an agency's reasoning," *Federal Election Comm'n v. Democratic Senatorial Campaign Comm.*, 454 U.S. 27, 37 (1981), and, second, the consistency of the agency's present interpretation with its earlier pronouncements, *Morton v. Ruiz*, 415 U.S. 199, 237 (1974); *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944).

The Board should have examined § 32 in its analysis of § 20 because—as the Supreme Court has indicated—"§§ 32 and 20 contain identical language, were enacted for similar purposes, and are part of the same statute." *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207, 219 (1984) (*Schwab*). Thus, an established interpretation of the language of one section is important in interpreting the language of the other. *See id.* In that respect, the Board's 120-page opinion is deficient.

The Board's earlier view of § 32 suggests that bank-eligible securities were *included* within the term "securi-

ties" in § 32. In 1936 the Board exempted from § 32 individuals dealing in or underwriting "bonds, notes, certificates of indebtedness, and Treasury bills of the United States." 22 Fed. Reserve Bull. 51, 52 (1936). As SIA argues, this suggests that the Board understood that bank-eligible securities were covered by § 32, because there was otherwise no need to exempt from § 32 individuals involved in those securities activities. At oral argument the Board's response to SIA's contention was that it had merely failed to explain its reasoning for the exemption, and that granting the exemption from the prohibitions of § 32 was done only for purposes of clarity.

This could be a plausible explanation, but in this instance we think it is not. Although in its current form Regulation R does exempt from § 32 individuals engaged in any securities activity permitted to banks under § 16, *see* 12 C.F.R. § 218.2 (1987), the exemption, as originally enacted, did not exempt *all* forms of bank-eligible securities, but only the obligations of the United States. Omitted from exemption were the general obligations of the States or their political subdivisions. *See* 22 Fed. Reserve Bull. at 52. From this it is obvious that the Board did not read § 32 as excluding *ab initio* all bank-eligible securities, but rather that it exercised the authority granted it by Congress under § 32—authority not granted in § 20—to create a narrow exemption for individuals dealing in United States government obligations. In addition, in a footnote to the 1936 regulation, the Board enumerated instances in which the terms of § 32 did not apply. *See* 22 Fed. Reserve Bull. at 51 n.1. Plainly, the Board knew how to say when § 32 did not apply to a certain activity, and how to state that a certain activity was subject to § 32,

but was nevertheless *exempted* pursuant by the Board under its statutory authority.

The Board's orders on appeal here are not instances where the Board failed to adopt an expressly articulated position on the meaning of § 20. *Cf. Investment Co. Inst. v. Camp*, 401 U.S. 617, 627-28 (1971) (*Camp*). Nonetheless, its failure to address—in what is an otherwise comprehensive and reasoned decision—the significance of its prior interpretation of § 32 counsels against granting it full deference. Our own review of the history of the Glass-Steagall Act leads us nonetheless to conclude that construing § 20 as not encompassing activities by bank affiliates in bank-eligible securities is essential if Congress' purpose in enacting § 20 is to be effectuated.

DISCUSSION

The two principal issues presented to this court are the Board's constructions of the terms "securities" and "engaged principally" under § 20 of the Glass-Steagall Act. The proper interpretation of § 20 is an issue of first impression and necessitates a comprehensive examination of both the relevant legislation and the events surrounding its enactment.

I *Glass-Steagall: A Statutory Overview*

The whole of the Banking Act of 1933, ch. 89, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.), is sometimes referred to as the Glass-Steagall Act. *See ICI*, 450 U.S. at 53. It is perhaps more accurate to consider §§ 16, 20, 21, and 32 of the Banking Act of 1933 in particular as the Glass-Steagall Act. *See Schwab*, 468 U.S. at 216 & n.15. These sections, the " 'Maginot Line' of the financial world," *see*

Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 Emory L.J. 1, 5 (1984) [hereinafter *Glass-Steagall Dilemma*] (quoting Bevis Longstreth, "Current Issues Facing the Securities Industry and the SEC," May 4, 1982 speech to the SIA), were meant to separate commercial and investment banking.[4]

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4 The Glass-Steagall Act originally contained a fifth section—§ 19(e)—which also was designed to effect a separation between commercial and investment banking. It read in pertinent part:

> (e) Every such holding company affiliate shall, in its application for such voting permit, (1) show that it does not own, control, or have any interest in, and is not participating in the management or direction of, any corporation, business trust, association, or other similar organization formed for the purpose of, or engaged principally in, the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail or through syndicate participation, of stocks, bonds, debentures, notes, or other securities of any sort (hereinafter referred to as 'securities company'); . . .

Pub. L. No. 73-66, ch. 89, § 19(e), 48 Stat. 162, 188 (1933), *repealed*, Pub. L. No. 89-485, § 13(c), 80 Stat. 236, 242 (1966).

Thus, § 19(e) was the Glass-Steagall Act provision that originally dealt with bank holding companies. Section 19(e) operated indirectly; bank holding companies were required to apply to the Reserve Board for a permit entitling them to exercise the voting rights of the shares of stock which they held in member banks. *See* 48 Stat. at 186. In order to obtain a voting permit, a bank holding company had to divest itself of ownership or control of its securities affiliate(s). The reason for this indirect method was Congress' hesitancy to legislate in regard to state-chartered institutions. *See* S. Rep. No. 77, 73d Cong., 1st Sess. 10 (1933); 75 Cong. Rec. 9905 (1932) (remarks of Sen. Walcott). Yet, § 19(e) was largely ineffectual because bank holding companies simply elected not to vote the shares of their securities affiliates. *See ICI*, 450 U.S. at 69-70. In addition, after the enactment of the Bank Holding Company Act of 1956, which broadened the Banking Act's definition of "affiliate," it became doubtful whether § 19(e) was "sufficiently useful to justify [its] retention." S. Rep. No. 1179, 89th Cong., 2d Sess. 12 (1966). The "loophole" therefore was closed by a 1966 amendment. *See* 80 Stat. at 242.

Section 16 of the Glass-Steagall Act applies to federally chartered banks and restricts their powers. In pertinent part, the statute as amended provides:

> The business of dealing in securities and stock by the [member bank] shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the [member bank] shall not underwrite any issue of securities or stock . . . . The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof . . . .

12 U.S.C. § 24 (Seventh) (1982 & Supp. IV 1986).

As can be readily seen, § 16 forbids national banks from underwriting "any issue of securities or stock"[5] and also limits their ability to deal in securities. As noted, it expressly excepts from its coverage underwriting and dealing in the obligations of the United States or general obligations of states or their political subdivisions, which we have termed "bank-eligible securities."

Section 21 seeks to draw the same line as § 16 does for commercial banks, but from the perspective of investment banks. *See Bankers Trust I*, 468 U.S. at 148. Section 21 as amended reads in pertinent part:

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5 As it was originally written, § 16 only prohibited underwriting "securities." *See* 48 Stat. at 185 (1933). One of the so-called "technical" provisions of the Banking Act of 1935 amended § 16 by adding "and stock" after the references to "securities." Banking Act of 1935, Pub. L. No. 74-305, ch. 614, tit. III, § 308(a), 49 Stat. 684, 709 (1935).

(a) After the expiration of one year after June 16, 1933, it shall be unlawful—

(1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: *Provided*, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 24 of this title . . . .

12 U.S.C. § 378(a)(1) (1982). Section 21 prohibits firms "*engaged*" in certain investment banking activities from undertaking commercial banking activities. *See Bankers Trust I*, 468 U.S. at 148; *ICI*, 450 U.S. at 62-63. As originally drafted and enacted it did not contain the § 16 proviso that allowed banks to underwrite and deal in bank-eligible securities. *See* Banking Act of 1933, § 21, 48 Stat. at 189. A 1935 amendment to § 21 made explicit that § 21 did not prohibit those activities permitted member banks under § 16. *See* Banking Act of 1935, Pub. L. No. 74-305, ch. 614, tit. III, § 303(a), 49 Stat. 684, 707 (1935).

Sections 32 and 20 are the Glass-Steagall Act's "remaining ramparts" in the line between commercial and investment banking. *Glass-Steagall Dilemma*, *supra*, at 6. Section 32 as amended reads in its entirety:

> No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, *primarily engaged* in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.

12 U.S.C. § 78 (1982) (emphasis added). Section 32 prohibits personnel "interlocks" between member banks and firms that are "*primarily engaged*" in the business of underwriting or dealing in securities. In its original form, the section authorized the Board to permit an individual exemption from the prohibitions of § 32. *See* Banking Act of 1933, § 32, 48 Stat. at 194. In 1935 Congress amended § 32 to allow the Board to promulgate a general regulation to exempt "classes of cases" from the reach of § 32. *See* Banking Act of 1935, § 307, 49 Stat. at 709. In 1936 the Board promulgated Regulation R, which exempted from § 32 individuals dealing in "bonds, notes, certificates of indebtedness, and Treasury bills of the United States." *See* 22 Fed. Reserve Bull. 51, 52 (1936).

The current version of Regulation R is found at 12 C.F.R. § 218.2 (1987).

Finally, § 20—the proper interpretation of which is the principal question presented on this appeal—provides in pertinent part:

> After one year from June 16, 1933, *no member bank shall be affiliated* in any manner described in subsection (b) of section 221a of this title *with any* corporation, association, business trust, or other similar *organization engaged principally in the issue*, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation *of stocks, bonds, debentures, notes, or other securities* . . . .

12 U.S.C. § 377 (1982) (emphasis added). As discussed above, the Board concluded that § 20 only proscribes member bank affiliation with firms "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of *bank-ineligible* securities, those which banks are prevented under § 16 from dealing in themselves. Throughout this opinion we have adopted, for clarity's sake, the term "underwriting and dealing in" to refer to "the issue, flotation . . ." language in § 20.

II *The Meaning of "Securities" in § 20*

When called upon to interpret the Glass-Steagall Act, judges "face a virtually insurmountable burden due to the vast dichotomy between the ostensible legislative intent and the actual motivations of Congress." *Glass-Steagall Dilemma*, *supra*, at 1-2. Divining the aim of Congress in enacting § 20 is particularly formidable because the issue of the proper relationship between commercial banks and

their affiliates caused considerable disagreement among legislators and experts who participated in the development of what became the Banking Act of 1933. *See generally* Perkins, *The Divorce of Commercial and Investment Banking: A History*, 88 Banking L.J. 483, 505-12 (1971) [hereinafter *Banking Divorce*]. Consequently, we approach the subject first by examining the legislative history of § 20, analyzing the Congressional compromise that resulted in the enactment of § 20, and then by looking at prior judicial construction of the Act.

A. *Legislative History*

1. *Envisioning § 20—Congress' Purpose*

The Act's legislative history reflects the notion that the underlying cause of the stock market crash in 1929 and subsequent bank insolvencies came about from the excessive use of bank credit to speculate in the stock market. *See* S. Rep. No. 77, 73d Cong., 1st Sess. 3-9 (1933) [hereinafter *1933 Senate Report*]; *see also* 75 Cong. Rec. 9883-84 (1932) (remarks of Sen. Glass) (criticizing transformation of the Federal Reserve System from a commercial banking system into one used for "stock-market speculative operations"). Bank affiliates were identified as a major factor in the overextension of credit for security loans. *See 1933 Senate Report*, *supra*, at 9-10.

Congress' concern was not limited solely to how securities affiliates contributed to the excesses in bank credit; its apprehension was far more fundamental and structural. Senator Bulkley, for example, repeatedly stressed that the debate over affiliates should not obscure "[t]he important and underlying question [of] whether banking institutions receiving commercial and savings deposits ought to be permitted at all to engage in the investment-security

business." 75 Cong. Rec. 9910 (1932). He argued that "[t]he existence of security affiliates is a mere incident to this question," *id.*, and reiterated that "the real question is not whether . . . banks shall be permitted to have investment-security affiliates but rather whether they should be permitted to engage in the investment-security business in any manner at all, through affiliates or otherwise," *id.* at 9911.

Two large problems attendant upon the involvement of a commercial bank in investment banking—either on its own or through use of an affiliate—were identified by Congress. The first was "the danger of banks using bank assets in imprudent securities investments." *ICI*, 450 U.S. at 66; *see also Camp*, 401 U.S. at 630. The second "focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments." *Camp*, 401 U.S. at 630.

In *Camp* the Supreme Court described these subtle hazards: loss of public confidence in a bank if its affiliate lost money; the temptation for a bank to shore up an affiliate through unsound loans; imprudent lending to companies in which the security affiliate has invested or become interested; possible loss of a bank's goodwill should its depositors suffer losses on investments that they purchased in reliance on the relationship between the bank and its affiliate; bank loans used for purposes of buying securities; commercial bank involvement in investment banking which might facilitate the loss of disinterested investment advice and encourage violations of fiduciary obligations. *Camp*, 401 U.S. at 631-33; *see*

Operation of the National and Federal Reserve Banking Systems, Hearings on S. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency, 71st Cong., 3d Sess. 1063-64 (1931) [hereinafter *1931 Hearings*]; 75 Cong. Rec. 9911-12 (1932) (remarks of Sen. Bulkley).

Sections 16 and 21 effectively barred commercial banks from *direct* engagement in investment banking, with the notable exception of government securities. Yet even before the 1929 crash, direct involvement by a bank had been considered "improper," *see Camp*, 401 U.S. at 629, but bank affiliates had developed as the medium for commercial banks' *indirect* entry into investment banking, *see id.* Even though the stock market debacle laid bare the dangers arising from the activities of securities affiliates, opinion was divided on how best to mitigate those dangers.

No one argued that the affiliate system had not been abused in the past, *see, e.g., 1931 Hearings, supra*, at 298-99 (remarks of Charles E. Mitchell, Chairman, National City Bank of New York). Experts believed that an adequate check on such abuse was to establish rigorous examination requirements for affiliates, which had remained largely unregulated before 1929. *See, e.g., id.* at 117 (testimony of J.H. Case, Chairman, Board of Directors of the Federal Reserve Bank of New York); *id.* at 192 (testimony of A.H. Wiggin, Chairman of the Governing Board, Chase National Bank); *id.* at 364 (testimony of O.D. Young, Chairman of the Board, General Electric Co.); *id.* at 405 (testimony of M.W. Traylor, Chairman of the Board, First National Bank of Chicago). Others thought that if the slate were wiped clean, affiliates should not be legal, but that in 1933 a complete divorce between commercial and investment banking was not

feasible given the established role of affiliates in the banking system. *See, e.g., id.* at 22 (testimony of J. Pole, Comptroller of the Currency); *id.* at 38-39 (testimony of G.L. Harrison, Governor, Federal Reserve Bank of New York); *id.* at 148 (testimony of A.C. Miller, Member, Federal Reserve Board).

Some advocated complete separation of the commercial and investment banking industries. *See, e.g., id.* at 231 (testimony of B.W. Trafford, Vice Chairman, First National Bank of Boston). Senator Glass—an adherent of this view—was of the opinion that a "complete separation" was both warranted and capable of being accomplished. *E.g., Operation of the National and Federal Reserve Banking Systems, Hearings on S.4115 Before the Senate Comm. on Banking and Currency*, 72d Cong., 1st Sess. 42, 267 (1932) (remarks of Sen. Glass) [hereinafter *1932 Hearings*]. Senator Glass' views are significant, of course, because of his role in drafting and shaping the Banking Act of 1933, a portion of which bears his name. *Cf. North Haven Bd. of Educ. v. Bell*, 456 U.S. 512, 526-27 (1982) (remarks of sponsor of language ultimately enacted "are an authoritative guide to the statute's construction"). Yet, despite the Senator's goal of complete separation, the Senate took a less drastic step. Acknowledging that "[i]t has been suggested . . . that the affiliate system be simply 'abolished,' " the Senate rejected this as impossible and stated that its goals toward regulating affiliates were to (1) separate "*as far as possible*" member banks from affiliates of all kinds; (2) limit advances or loans from parent to affiliate; and (3) install satisfactory examination requirements for affiliates. *1933 Senate Report, supra*, at 10 (emphasis added).

2. *Construing § 20—Congress' Compromise*

Section 20 was Congress' solution to the problem of affiliates and establishes the boundary separating banks from their security affiliates. While § 21 prohibits firms "engaged" in investment banking activities from accepting deposits, § 20 prohibits commercial bank affiliation with firms "engaged principally" in underwriting and dealing in securities. The inference following from this different terminology is obvious: § 20 applies a "less stringent standard" than the absolute bar between commercial and investment banking laid down by §§ 16 and 21. *ICI*, 450 U.S. at 60 n.26. Nor can the difference in terminology be attributed to oversight. Section 21 originally contained the term "engaged principally." In offering the amendment that deleted "principally," Senator Bulkley argued that "[i]t has become apparent that at least some of the great investment houses are engaged in so many forms of business that there is some doubt as to whether the investment business is the principal one." 77 Cong. Rec. 4180 (1933). Given that one of the leading advocates of Glass-Steagall recognized that "engaged" connoted a stricter standard than "engaged principally," it is inconceivable that the latter term could remain in § 20 by sheer happenstance. Thus, while the original impetus behind the Glass-Steagall bill on the floor of Congress may have been to sever completely the commercial and investment banking industries, it fell short of that goal—a victim of legislative compromise.

Legislative history also supports the view that § 20's use of the word "securities" did not imply a complete separation between commercial and investment banking. A colloquy between Senators Glass and Long is illuminating:

MR. LONG. I have been told that the Senator has said that he did not think this bill would prohibit the handling of Government and State bonds by the Federal reserve banks, that the Senator's provision against affiliates handling bonds was not intended to affect the handling of Government and State bonds.

MR. GLASS. They are expressly excluded from the terms of the bill.

MR. LONG. As to both affiliates and the banks?

MR. GLASS. As to affiliates? We are trying to abolish the affiliates in a period of years.

MR. LONG. The Senator has no objection, has he, to an affiliate handling them if they handle nothing but the Government and State Bonds under supervision, the same supervision the banks are given?

MR. GLASS. I am objecting to affiliates altogether. I am objecting to a national banking institution setting up a back-door arrangement by which it may engage in a business which the national bank act denies it the privilege of doing. If investment banking is a profitable business, who does not know that such business will be set up as a separate institution, not using the money and prestige and facilities of a national bank and its deposits to engage in investment activities? I want to make it impossible hereafter to have the portfolios of commercial banks filled with useless speculative securities, so that when stringency comes upon the country these banks may not respond to the requirements of commerce. That is what is the matter with the country to-day, and it is because this bill would avert a repetition of that

> disaster that intense and bitter opposition has been organized against it.

76 Cong. Rec. 2000 (1933). Senator Glass' aspiration to divorce completely commercial banks from their security affiliates was never attained: § 20 only prohibits affiliation with firms that are "engaged principally" in forbidden investment activity. SIA urges from the above colloquy that Senator Glass objected to affiliates' handling even securities that banks themselves could underwrite under the proposed legislation and that the Senator's view carried the day in § 20 as enacted. On the contrary, we believe Senator Glass' response to Senator Long indicates that he was primarily concerned with "back-door" arrangements between banks and their security affiliates that permitted affiliates to engage in the securities business denied by law to the bank itself. Senator Glass' reservation did not encompass affiliate activity in a business that § 16 grants to a bank "the privilege of doing."

Further, Senator Long's initial query indicates that the issue of whether affiliates ought to be able to engage in bank-eligible activities to the same extent as banks themselves was not dormant during the debates. Thus, Senator Long commented that those who had opposed some provisions in the bill "have seen some virtue in it. I particularly refer to the divorcing of the affiliates, except in so far as they handle municipal and Government bonds and securities." 76 Cong. Rec. 2274 (1933). To make certain affiliates had the same right to deal in government obligations, Senator Long had printed and circulated an amendment to the Glass-Steagall bill to that effect. Proposed Amend. to S. 4412, 72d Cong., 2d Sess. (Jan. 10, 1933). Despite Senator Long's repeated insistence that

§ 20 would not preclude bank-eligible activities by an affiliate, this amendment was never formally raised in debate. The Banking Act of 1933 became law five months later, on June 16, 1933, and it can be plausibly urged that the bill finally agreed upon and enacted into law made his amendment unnecessary. Recognizing the power of Senator Long's position, SIA argues that statements and actions taken during debate are not entitled to much weight. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 n.24 (1976). A look at subsequent events in this case illustrates the soundness of that rule. In 1935, just two years after his strong rhetoric in the Banking Act debate, Senator Glass himself supported a proposed amendment to that law granting to commercial banks the right to underwrite securities. 79 Cong. Rec. 11,827 (1935). So much for not having "the portfolios of commercial banks filled with useless securities."

Thus, it seems eminently reasonable to conclude from Senator Glass' response to Senator Long, as well as other evidence in the legislative history, that Congress' concern was primarily with bank affiliate activities in bank-ineligible securities. Bank affiliates often "devote[d] themselves . . . to perilous underwriting operations, stock speculation, and maintaining a market for the banks' own stock often largely with the resources of the parent bank." *1933 Senate Report, supra*, at 10. According to Senator Glass, "[w]hat the committee had foremost in its thought was to exclude from commercial banking all investment securities except those of an undoubted character that would be surely liquidated; and for that reason we made an exception [in § 16] of United States securities and of the general liabilities of States and subdivisions of States." 76 Cong. Rec. 2092 (1933). Given that Glass-

Steagall was a means to sever commercial banking only from more speculative, "perilous" investment activities, in which bank-eligible activities were not included, an interpretation of "securities" in § 20 that excludes bank-eligible securities from its reach is entirely consistent with Congress' aim.

The history of security affiliates in the United States also supports this view. Many banks formed security affiliates in order to handle the sale of government bonds used to finance World War I. B. Klebaner, *Commercial Banking in the United States: A History* 109-10 (1974); *Banking Divorce*, *supra*, at 490-91; *see also 1932 Hearings*, *supra*, at 29 (testimony of A.M. Pope, President, Investment Bankers' Ass'n of Am.). Banks were "expected" to aid the government in distributing war loans and were "encouraged" to aid potential investors by lending them the purchase price of government bonds. *Banking Divorce*, *supra*, at 491. It was not until the 1920's that affiliates began to expand into private debt and equity securities activities in response to the demands of the public and business. *See id.* at 493-96; *see also* 77 Cong. Rec. 3835 (1933) (remarks of Rep. Steagall) ("Our great banking system was diverted from its original purposes into investment activities, and its service devoted to speculation and international high finance."); 75 Cong. Rec. 9904-05 (1932) (remarks of Sen. Walcott) (businesses began to finance their requirements by sale of securities rather than by borrowing; growth of affiliates was "the outgrowth of the willingness of public to buy readily and without very much inquiry"). It was not the affiliate system as a concept that worried Congress, but the affiliate system as it had developed. The evil that Congress intended to attack was bank involvement in specula-

tive securities, that is, bank-ineligible securities. We cannot attribute to Congress a purpose to limit *all* securities activities when it consistently made clear that it was only concerned with *one type*.

An elucidation of SIA's suggested interpretation of § 20 shows the anomalies that an over-literal interpretation of the term "securities" in that section might bring. If bank-eligible securities are included in the prohibitions of § 20, an affiliate could "engage" (but not principally) in bank-ineligible securities activities. Alternatively, the same affiliate could engage to the identical extent in bank-eligible securities activities. SIA's construction would permit either, or both, types of activity—up to a certain point. Two banks could each have an affiliate, one engaged in underwriting and dealing in high-risk securities prohibited to banks, and the other engaged in the government obligations that Congress felt to be of such negligible risk that it allowed, and encouraged, banks themselves to deal in them. It is paradoxical to presume that it was Congress' purpose to place both affiliates on the same footing.

A subsequent amendment to the Glass-Steagall Act also argues against too strict a construction of § 20. As mentioned earlier, Congress amended § 21 in 1935 to "make it clear that [§ 21] does not prohibit any financial institution or private banker from engaging in the securities business" to the extent permitted in § 16. H.R. Rep. No. 742, 74th Cong., 1st Sess. 16 (1935); *see also* S. Rep. No. 1007, 74th Cong., 1st Sess. 15 (1935); S. Rep. No. 1260, 73d Cong., 2d Sess. 2 (1934). SIA claims that because § 20 was also amended at the same time, *see* H.R. Rep. No. 742, 74th Cong., 1st Sess. 16 (1935) (amendment to § 20 regarding formalities of affiliate liquidation), the

failure to add to § 20 a similar proviso indicates a deliberate legislative determination that § 16 activities are within the scope of § 20. We cannot agree.

First, this argument belies the *clarifying* nature of the amendment to § 21. *See Bankers Trust II*, 807 F.2d at 1057-58. Second, we decline to hold that in failing to amend § 20 in the same manner Congress planned to clarify the meaning of the term "securities" by its silence. There is evidence that the Banking Act of 1933 itself was not the driving force that caused banks to divest themselves of their affiliates. Instead, economic conditions and Congress' investigation into stock market practices were instrumental in bringing banks to divorce themselves *voluntarily* from their affiliates. *See* B. Klebaner, *supra*, at 140; *Banking Divorce*, *supra*, at 522-24. Given this voluntary divestiture, § 20 became much less of a controversy in practice than it had been in legislative debate. Viewed in that perspective, it is not so unusual that Congress failed to amend § 20 in order to "clarify" the intent of that section as it had with § 21.

Finally, amicus Investment Company Institute (ICI) argues that repealed § 19(e)'s definition of securities—"securities of any sort"—confirms that "securities" in § 20 must mean both bank-eligible and bank-ineligible securities. To the contrary, "securities of any sort" is just as ambiguous as the word "securities" standing alone, and the phrase is vulnerable to the same construction as that advanced for § 20.

Thus, the legislative history strongly supports the view that "securities" in § 20 only refers to bank-ineligible securities.

B. *Prior Judicial Construction*

The compromise aspect of § 20 exposes the difficulties of fitting this case comfortably within the traditional "subtle hazards" analysis developed in *Camp* and used by the Supreme Court in subsequent Glass-Steagall Act cases. Under this analysis, the Court noted the hazards that Congress sought to prevent when the Act was passed and then examined whether a particular activity would implicate them. *See Schwab*, 468 U.S. at 220-21; *Bankers Trust I*, 468 U.S. at 154-60; *ICI*, 450 U.S. at 66-68; *Camp*, 401 U.S. at 630-34. By using in § 20 the language "engaged principally" rather than a more restrictive term, Congress expressed a legislative choice to tolerate at least some of those hazards. This situation is not entirely inconsistent with subtle hazards analysis—which never controlled the result in a Glass-Steagall case but only reinforced a conclusion already reached as a matter of statutory interpretation. *See Bankers Trust II*, 807 F.2d at 1069. Nor, for that matter, has the existence of one hazard required reversal of the Board: a hazard need not "be 'totally obliterated' to permit a banking practice—avoidance of the hazard 'to a large extent' suffices." *Id.* (quoting *ICI*, 450 U.S. at 67 n.39).

Accordingly, in reviewing the Board's determination that § 20 does not encompass bank-eligible securities, we give due regard not only to the hazards inherent in affiliation, but also to the manner in which Congress ultimately addressed those hazards through § 20. *See Commissioner v. Engle*, 464 U.S. 206, 217 (1984); *Southeastern Community College v. Davis*, 442 U.S. 397, 411 (1979). As the Supreme Court stated in *Board of Governors of the Federal Reserve System v. Dimension Financial Corp.*, 474 U.S. 361 (1986):

> Application of "broad purposes" of legislation at the expense of specific provisions ignores the complexity of the problems Congress is called upon to address and the dynamics of legislative action. Congress may be unanimous in its intent to stamp out some vague social or economic evil; however, because its Members may differ sharply on the means for effectuating that intent, the final language of the legislation may reflect hard-fought compromises. Invocation of the "plain purpose" of legislation at the expense of the terms of the statute itself takes no account of the processes of compromise and, in the end, prevents the effectuation of congressional intent.

474 U.S. at 373-74.

In light of these principles, the Court's subtle hazards analysis does not preclude the Board's construction of § 20. As noted, Congress was not concerned with affiliation *per se*, but rather with the dangers attendant upon the entry of commercial banks into the investment banking field either directly or indirectly. Yet even after acknowledging these perils, Congress allowed banks to underwrite and deal in bank-eligible securities under § 16, making it plain therefore that it believed the risks were not so great when banks dealt in these securities. As Senator Bulkley stressed, whether or not a bank chooses to engage in these activities itself or through an affiliate is relatively unimportant compared to the question of whether a bank should engage in them at all. Since banks are allowed under § 16 to underwrite and deal in government obligations without limitation, it would be incongruous for § 20 to prohibit banks from affiliating with entities that are merely "engaged principally" in those same activities.

Further, the Supreme Court observed that "[i]n both the Glass-Steagall Act itself and in the Bank Holding Company Act, Congress indicated that a bank affiliate may engage in activities that would be impermissible for the bank itself." *ICI*, 450 U.S. at 64. Similarly, in *Schwab* the Court commented that "the fact that § 16 of the Glass-Steagall Act allows banks to engage directly in [a service] suggests that the activity was not the sort that concerned Congress in its effort to secure the Nation's banks from the risks of the securities market." 468 U.S. at 221. The same principle necessarily applies here. As we recently stated, "the latitude the Act grants bank holding companies partially to engage in activities such as underwriting, which implicate the Act's policies whether conducted by banks or by bank holding companies, suggests that bank holding companies can, under the Act, be allowed principally to engage in activities which pose the dangers the Act addressed only when conducted by banks." *Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys.*, 716 F.2d 92, 100 (2d Cir. 1983), *aff'd*, *Schwab*, 468 U.S. 207 (1984). Because underwriting and dealing in government securities pose no hazards to banks themselves, *a fortiori* bank affiliates should be able principally to engage in the same activity.

In sum, the Board's construction of Glass-Steagall is not only reasonable, but dictated by a thorough examination of the legislative history of Glass-Steagall and of the hazards that Congress sought to prevent when enacting § 20. We hold that it was not Congress' purpose in § 20 to preclude a bank affiliate from engaging in the same activities to the same extent as a member bank and we uphold the Board's determination that the reference in

§ 20 to "securities" does not encompass those securities which § 16 allows banks themselves to underwrite.

III "*Engaged Principally*"

We now turn to the Board's determination of when a security affiliate is "engaged principally" in activities covered by § 20. In their applications the bank holding companies sought to comply with the "engaged principally" standard of § 20 by proposing limitations on their underwriting and dealing in bank-ineligible securities. J.P. Morgan & Co., for example, proposed that its bank-ineligible securities activities would not exceed during any rolling two-year period 15 percent of its total business. J.P. Morgan & Co. Proposal, 50 Fed. Reg. 41,025 (1985). It proposed a combination of accounting tests to measure its compliance with the 15 percent limitation.[6] The other companies proposed total volume limits of ten to 15 percent of their total business.

The Board rejected these proposals. Following the analysis set forth in its *Bankers Trust* order, 73 Fed.

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6 The limitation would be met if two of the following three tests were satisfied:

(1) The dollar volume of underwriting commitments [or underwriting sales if larger] and dealer sales attributable to ineligible securities activities with the total dollar volume of all of JPMS's activities;

(2) The average assets acquired in connection with ineligible securities activities with the average assets acquired in connection with all of JPMS's activities; and

(3) The gross income [i.e., income before expenses and taxes] from ineligible securities activities with the gross income from all of JPMS's activities.

50 Fed. Reg. 41,025 (1985). "JPMS" is a wholly-owned subsidiary of J.P. Morgan Securities Holdings Inc., which is itself wholly-owned by J.P. Morgan & Co. Inc.

Reserve Bull. 138 (1987), the Board concluded that "engaged principally" in § 20 denotes any "substantial" bank-ineligible activity. *See* 73 Fed. Reserve Bull. at 482. Measured quantitatively, the Board stated that an affiliate would not be principally or substantially engaged in bank-ineligible activities if: (1) the gross revenue from § 20 activities did not exceed five to ten percent of the affiliate's total gross revenues (gross revenue limitation or gross revenue test); and (2) the affiliate's activities in connection with *each* particular type of ineligible security did not account for more than five to ten percent of the total amount of that type of security underwritten domestically by all firms (or, with commercial paper, the average amount of dealer-placed commercial paper outstanding) during the previous calendar year (market share limitation or market share test).[7] Applying this measure to the applications before it, the Board selected the lower five percent figure for both gross revenue and market share limitations. It recognized that this was a "conservative approach," but stated that it would review the limitations within one year of the implementation of its orders. 73 Fed. Reserve Bull. at 485.

The bank holding companies petition for review of this interpretation of "engaged principally." First, they argue that the Board's view contravenes Supreme Court precedent. Second, they contend that the limitation is inconsistent with the language, structure, and legislative intent of

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[7] The Board was unpersuaded, as we are, that § 20 permits two or more affiliates to combine their total gross incomes for purposes of determining whether or not the affiliates are "engaged principally" in ineligible activity. 73 Fed. Reserve Bull. at 486 n.45. The reason is plain. The provisions of § 20 apply to each individual company affiliated with a member bank.

the Glass-Steagall Act. Finally, cross-petitioner Security Pacific Corporation argues that the Board erred in adopting an inflexible percentage test instead of approaching each affiliate's application on a case-by-case basis.

The term "engaged principally" is intrinsically ambiguous. As discussed above, we must uphold the Board's interpretation if it is reasonable. Unlike the facts presented on the issue of the scope of § 20, the Board's position here does not contradict its prior interpretations. Accordingly, we defer to the Board's construction of § 20.

A. *Agnew*

The Board found that "principally" in § 20 means "substantially." The banks urge that in *Board of Governors of the Fed. Reserve Sys. v. Agnew*, 329 U.S. 441 (1947), the Supreme Court decided that "principally" means something more than substantially, and therefore that the Board's decision conflicts with *Agnew*.

In *Agnew* the Board issued an order that required the removal of directors of a national bank because of their affiliation with a company which, in the Board's view, was "primarily engaged" in underwriting securities as prohibited by § 32 of the Act. The United States Court of Appeals for the District of Columbia reversed the Board and held that a company is not "primarily engaged" in underwriting unless the activity is its chief or principal activity—one exceeding 50 percent of the company's business. *See Agnew*, 153 F.2d 785, 790-91 (D.C. Cir. 1946). The Court of Appeals rejected the Board's argument that "primarily" in § 32 could mean "substantially" or "importantly."

The Supreme Court reversed, holding that "primarily" in § 32 meant "substantially." 329 U.S. at 446. In support of that conclusion, the Court noted that Congress used three different terms in the Glass-Steagall Act to describe underwriting firms: (1) those merely "*engaged*" in underwriting (§ 21); (2) those "*primarily engaged*" in underwriting (§ 32); and (3) those "*engaged principally*" in underwriting (§ 20). 329 U.S. at 448. It then concluded that "[t]he inference seems reasonable to us that Congress by the words it chose marked a distinction which we should not obliterate by reading 'primarily' to mean 'principally'." *Id.* Because the Board has found that a gross income level of ten percent of covered activities will trigger § 32, *see* Staff Opinion 3-939, 1 Fed. Reserve Reg. Serv. 389 (Dec. 14, 1981), the holding companies argue that "principally" under § 20 mandates approval of a higher level of activity, and that their proposed ten to 15 percent limitations were well within that level.

The statements in *Agnew* regarding the meaning of "principally" are not dispositive in the instant case. For one thing the meaning of § 20 was not before the Supreme Court in that case. *See Cohens v. Virginia*, 19 U.S. (6 Wheat.) 264, 398 (1821). Further, the statements concerning § 20 are not essential to its holding that "primarily" means "substantially." *See Kastigar v. United States*, 406 U.S. 441, 454-55 (1972). The main focus of the Court's analysis is on definitions of "primary," *see* 329 U.S. at 446, and on the perils Congress sought to check by enacting § 32, *id.* at 447. In fact, the brief discussion of § 20 is used to demonstrate that "[t]here is other intrinsic evidence in the Banking Act of 1933 to support our conclusion [on the meaning of "primary"]." *Id.*

Hence, we read *Agnew* as holding only that "primarily engaged" in § 32 means any "substantial activity."

B. "*Substantially*"

The Board's construction of "engaged principally" as denoting any substantial activity is reasonable. We do not conclude that because "engaged principally" in § 20 and "primarily engaged" in § 32 both denote "substantial activity" that the two terms are therefore synonymous. Substantiality is an amorphous qualitative concept that has many quantitative definitional manifestations, *see The Shorter Oxford English Dictionary* 2172 (3d ed. 1973), which vary with the context in which the term is used. Hence, the *Agnew* dicta that "engaged principally" and "primarily engaged" do not necessarily mean the same thing, *see* 329 U.S. at 448-49, is not entirely circumscribed by the Board's interpretation. In fact, the same considerations that compelled the Court in *Agnew* to conclude that "primarily" in § 32 means "substantially" apply equally—if not more forcefully—here.

The Supreme Court in *Agnew* rejected a reading that "primarily" meant "chief" or "leading" because the concerns that Congress addressed in enacting § 32 do not vanish if the firm's underwriting activities are 49 percent rather than 51 percent. *See* 329 U.S. at 447. In both situations, "a bank director interested in the underwriting business may use his influence in the bank to involve it or its customers in securities which his underwriting house has in its portfolio or has committed itself to take." *Id.* The banks' argument essentially adopts the Court of Appeals holding in *Agnew*, that is, "principally" means "chief" or "first." But the same reasoning that guided the Supreme Court guides us. The worries envisioned by

bank affiliation with securities firms do not disappear simply because the activity is less than 50 percent of a firm's business.

An example illuminates how equating "principally" in § 20 with "chief" or "first" begets the dangers foreseen by Congress. Such an interpretation would allow a member bank to become affiliated with any large integrated securities firm. One commentator has pointed out that reading "principally" as "chief" would allow a bank to be affiliated with Merrill Lynch & Co., Inc., one of the nation's largest investment bankers. *See* Plotkin, *What Meaning Does Glass-Steagall Have for Today's Financial World?*, 95 Banking L.J. 404, 414-16 (1977). It cannot be supposed that the Congress that enacted Glass-Steagall would have intended that § 20 not prohibit such affiliations. This is not to say that "principally" cannot in some contexts mean "chief" or "first," but rather that in § 20 the term must be given a definition that is both sensible *and* in harmony with legislative purpose.

Moreover, the logic of the holding companies' position is that "principally" in § 20 is a directly quantitative, not a qualitative, term. "Substantially," on the other hand, reflects the qualitative aspects of "principally." When Congress wanted to use a quantitative test in the Banking Act of 1933, it knew how to do it. *See* § 2(b), (c), 48 Stat. at 162-63 (definition of affiliate); § 13, 48 Stat. at 183 (collateral requirements for loans to affiliates); § 16 (Seventh), 48 Stat. at 185 (limitations on banks' purchase of securities for own account), § 19(b), 48 Stat. at 187 (level of assets for holding company affiliates to be maintained free of any liens); § 19(c), 48 Stat. at 187 (shareholders' liability determination). Because in § 20 Congress departed from a quantitative approach, the argument that a

qualitative test should be controlling is all the more compelling.

SIA and ICI advance several arguments against the Board's interpretation of "principally." They assert that "engaged principally" in § 20 at least covers any firm "formed for the purpose of" underwriting securities, relying on the Supreme Court's statement in *ICI* regarding repealed § 19(e) that "[a]ll companies formed for the purpose of issuing or underwriting securities would surely meet the 'engaged principally' test." 450 U.S. at 70 n.43. Concededly, the subsidiaries here were formed for the purpose of engaging in securities activities.

Yet, this argument is unpersuasive too. The Court's statement in *ICI* is dicta and seems to indicate nothing more remarkable than that a company formed for the purpose of underwriting securities most likely would be expected to be engaged principally in that activity. Further, since § 20 does not restrict bank-eligible securities activities, SIA and ICI arguably miss the point. Companies formed for the purpose of dealing in bank-eligible securities would not fall within the prohibitions of § 20.[8]

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8 SIA and ICI point to testimony that at least one affiliate was formed for the purpose of dealing in *bank-ineligible* securities. The President of J.P. Morgan & Co. said during the Board hearing that the holding company established its bank-eligible securities subsidiary because it thought that there might be changes in the law allowing dealing in a wider range of securities and that they wanted to have a subsidiary in place when those changes came about. Because we hold that § 20 allows affiliates to engage to a greater extent in securities than the banks themselves, *any* formation of an affiliate would likely have in part a purpose to engage in those activities prohibited to banks. SIA's argument therefore is also a back-door attempt to have us broaden the scope of § 20 to include bank-ineligible securities, an argument we have rejected.

To support their argument, SIA and ICI also rely on former § 19(e) of the Glass-Steagall Act. Section 19(e)—repealed in 1966—indirectly limited bank holding companies' acquisition of subsidiaries "formed for the purpose of, or engaged principally in" prohibited securities activities. 48 Stat. at 188; *see also supra* note 4. Because § 20 and § 19(e) were intended to accomplish the same result, SIA and ICI argue that we should read the two sections as being coextensive.

Even assuming that SIA and ICI are correct, § 19(e) would not have prohibited the activities here approved. It originally was intended to apply to "any affiliate formed for the purpose of, or *engaged* in" securities activities. *See 1932 Hearings*, *supra*, at 13 (text of proposed § 20(e)) (emphasis added). As originally conceived, *any* securities activity was prohibited under § 19(e). Thus, there are only two situations when the term "formed for the purpose of" had any meaning independent from "engaged in": when a company had been formed for the purpose of *engaging* in unpermitted activities, but had (1) not yet commenced activities, or (2) ceased the activities, but might possibly resume them. Plainly, the evil that the "formed for the purpose of" standard was designed to avoid was the formation of subsidiaries ready to "engage"—but not yet engaged—in unauthorized securities activities.

Congress eventually added the term "principally" to "engaged" in § 19(e), presumably to have § 19(e) correspond with the standard laid down in § 20. We think that the original meaning of the "formed for the purpose of" language in § 19(e) was retained after this amendment to qualify the new and less restrictive standard of "engaged principally." Thus, § 19(e) prevented subsidiaries from

either engaging principally in banned activities—which we have held above to be only bank-ineligible activities—*or* being formed for the purpose of engaging principally in such activities. Even if the proscriptions of § 20 are coextensive with those of former § 19(e), none of the subsidiaries here has been formed for the purpose of engaging *principally* in bank-ineligible activities. Section 19(e) therefore would not apply.

Alternatively, SIA claims that Congress intended that § 20 bar underwriting or dealing activities that constitute a "regular" or "integral" part of the affiliate's business, as opposed to "incidental" or "occasional" activities. The activities that concerned Congress did not necessarily arise only with the frequency of their repetition. In any event, the Board's interpretation of "principally" as any "substantial" activity adequately addresses any apprehension arising from the frequency or integral nature of an activity.

The final argument raised by SIA is that because the Board's interpretation of "engaged principally" necessitates regulation, it *a fortiori* contravenes the Glass-Steagall Act. It is true that "Congress rejected a regulatory approach when it drafted the statute." *Bankers Trust I*, 468 U.S. at 153. The Board's interpretation is one that attempts to walk the line that Congress laid down. The mere necessity of "regulation" in carrying out Glass-Steagall's "prohibitions" is insufficient to justify rejection of an otherwise reasonable interpretation of the Act. *Cf. Bankers Trust II*, 807 F.2d at 1067 ("The Glass-Steagall Act does impose a system of flat 'prohibitions' and 'prophylactic' measures, but this cannot obviate the need to examine particular factual situations to determine on which side of the prohibitory line they fall.").

Consequently, the Board's view of "engaged principally" as meaning any substantial activity is reasonable and consistent with Congressional purpose.

C. *Gross Revenue Limitation*

The Board determined that substantial activity, measured quantitatively, constituted five to ten percent of an affiliate's gross revenues over a two-year period. 73 Fed. Reserve Bull. at 485. It set the approved level of activity at the five percent end of this range, but stated its intent to review this level within a year after the order's effective date. *Id.*

One troublesome facet of the Board's ruling is that "engaged principally" in § 20 is equally restrictive as—if not *more* restrictive than—"primarily engaged" in § 32. The Board has stated that if a firm's prohibited activities constitute less than ten percent of its gross business, *see* Staff Opinion 3-939, 1 Fed. Reserve Reg. Serv. 389 (Dec. 14, 1981), or amount to less than ten million dollars regardless of the percentage figure, *see* Board Letter 3-896, 1 Fed. Reserve Reg. Serv. 367 (May 22, 1959), the firm is not "primarily engaged" in such activities under § 32. By placing the permissible level of § 20 activity currently at only five percent of gross revenues—and never more than ten percent—the Board is employing, at least for the present, a more restrictive gross revenue test for § 20 than for § 32.

This initially seems to contradict the Supreme Court's indication that §§ 32 and 20 should be interpreted consistently. *See Schwab*, 468 U.S. at 219 (the term "public sale" should be interpreted consistently because "§§ 32 and 20 contain identical language, were enacted for similar purposes, and are part of the same statute."). But with

regard to "engaged principally" versus "primarily engaged," §§ 20 and 32 differ; accordingly, there is justification for interpreting them slightly differently.

The legislative history also supports the conclusion that the Board's stringent quantitative interpretation of § 20 is reasonable. What became § 20 was proposed by Eugene Meyer, a governor of the Federal Reserve Board, as a *substitute* for the section which eventually became § 32, *see 1932 Hearings*, *supra*, at 387-88, because he believed that the language in the predecessor to § 32—in relevant respects identical to § 32—was overbroad and that it would therefore be ineffectual. *See id.* at 387. Meyer commented on the "difficulties in the way of accomplishing a complete divorce of member banks from their affiliates arising from the fact that a law intended for that purpose is likely to be susceptible of evasion or else to apply to many cases to which it is not intended to apply," *id.* at 388, and tentatively suggested substituting what is now § 20 for what is now § 32. It defies logic that § 20 should be interpreted *less* restrictively than § 32, based on Meyer's comments that § 20 was intended to be *more* restrictive than § 32.

Further support for a stricter interpretation of § 20 than of § 32 is derived from the fact that the dangers resulting from affiliation are arguably greater than those resulting only from personnel interlocks. The public associates a member bank and its affiliate because of their common ownership and often similar names. The potential for the public to associate the misfortunes of the affiliate with the bank is far greater than the association of firms with personnel interlocks, which are generally unknown to the public.

Given these considerations, we defer to the Board's determination that § 20 allows an affiliate to engage in bank-ineligible securities activities so long as those activities do not exceed five to ten percent of the affiliate's gross revenue. This range is both reasonable and consistent with the statute. Because of the Board's expertise we also defer to its decision to set the gross revenue limitation at five percent.

D. *Market Share Limitation*

The Board's second limitation on the subsidiaries' bank-ineligible securities activities provides that the subsidiaries' involvement in *each* activity may not exceed a five percent share of the total market for that activity. It reasoned that it has employed a market share limitation in determining whether a firm is "primarily engaged" in securities activities within the meaning of § 32. 73 Fed. Reserve Bull. at 484. The Board stated that "the fact that an affiliate would be a major force in a particular securities market would be an evidentiary factor suggesting that the affiliate is 'engaged principally' in underwriting securities." *Id.* It also concluded that a sales volume test—currently employed under its interpretation of § 32—would be subject to manipulation and that a market share test "would provide a useful and objective proxy for sales volume." *Id.* It was concerned that sales volume could be easily inflated by use of repurchase and reverse repurchase agreements for government securities—a common practice among government securities dealers—or by "churning." *Id.*

The bank holding companies argue that neither § 20 nor the legislative history of the Glass-Steagall Act provides a basis for the Board's market share test. They

assert that § 20 mandates an inquiry only into activities *within* a subsidiary rather than one into the size of the subsidiary's activity in relation to the market as a whole. A market share test, they claim, is intended *sub silentio* to promote competition rather than to protect against the hazards of affiliation envisioned by Congress.

The Board's justifications for imposing a market share limitation are not persuasive. It cites only two instances in which it has relied on market share data under § 32. One citation is to a 1947 internal letter from the Board to the Federal Reserve Bank of New York. The second citation is to a 1948 letter now included in a compilation of Board interpretations of Regulation R. *See* Fed. Reserve Reg. Serv. ¶ 3-895 (1948). The 1948 interpretative letter apparently was intended as a guide for future decisions.

It is true that § 32 implicitly delegates to the Board the power to determine when a firm is "primarily engaged" in securities activities, in the same way that § 20 implicitly delegates the power to determine when a firm is "engaged principally" in securities activities. Yet Congress chose to grant the Board power to exempt individuals from § 32, but did not grant it similar power in § 20. Since Congress expressly granted the Board different regulatory power in § 32 than in § 20, it does not at all follow that the Board's power to define the meaning of § 20 is coextensive with its power under § 32. Thus, the Board's reliance on § 32 is not dispositive.

We discern no support in § 20 for the Board's market share limitation. In the legislative history there is evidence that before the enactment of Glass-Steagall, banks and bank affiliates had acquired an increasingly large share of securities activity in relation to investment banks. *See* W. Peach, *The Security Affiliates of National Banks* 108-10

(1941). For example, between 1927 and 1930 the percentage share of commercial banks in origination of bond issues more than doubled. *Id.* at 109. This increasing market share of commercial banks in traditional investment banking activities was not unknown to Congress. *See 1931 Hearings, supra*, at 299 (testimony of C.E. Mitchell, Chairman, National City Bank of New York) (presenting data). But, the fact that this was brought to Congress's attention and that Congress did not directly address it is, if anything, a strong indication that Congress was not concerned about market share. Rather, by using the term "engaged principally," Congress indicated that its principal anxiety was over the perceived risk to bank solvency resulting from their over-involvement in securities activity. A market share limitation simply does not further reduce this congressional worry.

In addition, the Board has not proven on the record before us that a market share limitation is an objective proxy for a sales volume test. The Board makes no claim that the Act empowers it to limit the power of bank affiliates to compete in the securities markets open to them. Consequently, the banks' cross-petition to eliminate the market share limitation is granted.

E. *Security Pacific's Claims*

Security Pacific proposed in its application that its subsidiary engage in bank-ineligible securities activities constituting up to 15 percent of the subsidiary's gross revenues. The Board approved a lower level of up to five percent of gross revenues, consistent with its orders approving the other subsidiaries' activities. Security Pacific argues that the Board abused its discretion in setting the lower limitation and by failing to adopt a case-by-case

approach to determining appropriate levels of § 20 activity.

The gravamen of Security Pacific's argument is that its subsidiary should not be equated with the other bank holding company subsidiaries, all of which are based in New York. Security Pacific is located in California. The New York subsidiaries, Security Pacific argues, will be able to engage in a higher level of *bank-eligible* activities and, consequently, a higher level of *bank-ineligible* activities, since bank-ineligible activity levels correspond directly with the total securities activity of the subsidiary. Security Pacific claims that this mandates allowing a higher level of activity for its subsidiary.

We disagree. Section 20 must be read to set down at some point a hard and fast limit on the amount of bank-ineligible securities activity, and we have determined that the Board's limit of five to ten percent of the gross revenue is reasonable. Beyond this limit, there is no room for adjustment in order to ameliorate competitive inequality.

Within the range set by the Board there is, of course, leeway for adjustments that reflect the competitive positions of certain subsidiaries. Security Pacific declined to submit evidence of special circumstances that might distinguish it from the other affiliates involved and warrant approval of a level of bank-ineligible activity greater than five percent. Given this failure, the Board's approval of a five percent level for Security Pacific was not an abuse of its discretion.

Security Pacific also argues that the Board's limitations are inconsistent with Board precedent holding that quantitative measures should be determined on a case-by-case

basis. As noted above, § 20 sets down a line that cannot be crossed no matter how exceptional the circumstances, and it cannot be drawn differently in each case.

CONCLUSION

In sum § 20 of the Glass-Steagall Act forbids member bank affiliation with firms that are "engaged principally" in underwriting or dealing in "securities." It was not Congress' plan to forbid affiliates from those activities that banks themselves could engage in without limitation. The Board's interpretation of § 20 under which government securities—those that banks may without limitation underwrite and deal in—are excluded from the prohibition contained in § 20 is therefore consistent with the Congressional scheme. The Board's qualitative and quantitative constructions of the term "engaged principally" are reasonable, with the exception of the market share limitation. Accordingly, we deny the petitions and cross-petitions for review except with respect to the market share limitation.

Petitions and cross-petitions for review are denied save for the cross-petition for review that seeks to eliminate the market share limitation, which cross-petition is granted.

APPENDIX B

Citicorp
New York, New York

J.P. Morgan & Co. Incorporated
New York, New York

Bankers Trust New York Corporation
New York, New York

Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities

Citicorp, J.P. Morgan & Co. Incorporated, and Bankers Trust New York Corporation, New York, New York (collectively "Applicants"), bank holding companies within the meaning of the Bank Holding Company Act ("BHC Act"), have each applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage through wholly owned subsidiaries, Citicorp Securities, Inc. ("CSI"), J.P. Morgan Securities Inc. ("JPMS"), J.P. Morgan Municipal Finance Inc. ("JPMMF"), and BT Securities Corporation ("BTSC"), respectively, in underwriting and dealing in, on a limited basis, certain securities that member banks may not underwrite and deal in, specifically:

(1) municipal revenue bonds, including so-called "public ownership" industrial development bonds;[1]

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1 The industrial development bonds covered by the applications are only those tax exempt bonds in which the governmental issuer, or the governmental unit on behalf of which the bonds are issued, is the owner for federal income tax purposes of the financed facility (such as airports, mass commuting facilities and water pollution control facilities).

(2) mortgage-related securities (obligations secured by or representing an interest in residential real estate);

(3) consumer-receivable-related securities ("CRRs") (obligations secured by or representing an interest in loans or receivables of a type generally made to or due from consumers); and

(4) commercial paper.[2]

These securities (hereinafter "ineligible securities") may be held by member banks for investment purposes under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24, Seventh), but may not under that section be underwritten or dealt in by member banks.

Applicants have previously received Board approval under section 4(c)(8) of the BHC Act for the above-mentioned subsidiaries (collectively the "underwriting subsidiaries") to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Glass-Steagall Act (hereinafter "eligible securities").[3] These eligible securities include certain municipal revenue bonds (issued for certain housing, university or dormitory purposes) as well as mortgage-related securities issued or sold by certain agencies of the federal government. The proposed new underwriting and dealing activities would be provided in addition to the previously approved activities, with the subsidiaries serving customers

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2 J.P. Morgan has not proposed to underwrite and deal in CRRs. Citicorp's present application does not cover commercial paper, although it has filed a separate application with the Board to underwrite commercial paper.

3 These activities are authorized for bank holding companies under section 225.25(b)(16) of Regulation Y. 12 C.F.R. § 225.25(b)(16). In general, member banks may underwrite and deal in obligations of the United States, general obligations of states and political subdivisions, and certain securities issued or guaranteed by government agencies. 12 U.S.C. §§ 24 Seventh, and 335.

through offices in New York and, in the case of Citicorp, in several other cities in the United States.[4]

Citicorp, with total consolidated assets of $196 billion, is the largest banking organization in the nation.[5] It operates eight banking subsidiaries and engages directly and through subsidiaries in a broad range of permissible nonbanking activities. J.P. Morgan & Co. Incorporated, with total consolidated assets of $76 billion, is the fourth largest banking organization in the nation. It operates two subsidiary banks and engages directly and through subsidiaries in a variety of permissible nonbanking activities. Bankers Trust New York Corporation, with total consolidated assets of $56.4 billion, is the eighth largest banking organization in the nation. It also operates two subsidiary banks and engages directly and through subsidiaries in a variety of nonbanking activities.

Notice of the applications, affording interested persons an opportunity to submit comments on the proposals, has been published (50 *Federal Register* 20,847 and 41,025 (1985) and 51 *Federal Register* 16,590 (1986)). In addition, on December 31, 1986, the Board announced that it would hold a public hearing on February 3, 1987, on the applications, and requested specific comment on certain major issues, including a framework of prudential limitations to address the potential for conflicts of interest, unsound banking practices and other adverse effects raised by the proposals.

Four commenters, including the Securities Industry Association ("SIA"), a trade association of the investment banking industry, and the Investment Company Institute ("ICI"), a trade association of the mutual fund industry, opposed one or more of the proposals (collectively the "protestants"). The majority of the written comments were from banking organizations and trade associations representing segments of the banking industry and were in favor of the proposals. The Antitrust Division

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4 For purposes of the Order, in accordance with common industry usage, the term dealing refers to the business activity of holding oneself out to the public as being willing to buy and sell securities as principal in the secondary market.

5 All asset data are as of December 31, 1986.

of the U.S. Department of Justice and the U.S. Treasury Department also supported approval of the proposals.

Because each of the underwriting subsidiaries that propose to underwrite and deal in the ineligible securities would be affiliated through common ownership with a member bank, the Board must determine whether, upon consummation, the subsidiaries would be "engaged principally" in underwriting or the public sale of securities within the meaning of section 20 of the Glass-Steagall Act.[6] If so, the Board may not approve the applications.[7] In addition, the Board must determine whether the proposed activities are so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and are, on this basis, activities in which bank holding companies may engage.

In two previous decisions, the Board considered some of the issues that are raised in the applications now before the Board. On December 24, 1986, the Board approved the application of

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6 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) provides that:

> ". . . no member bank shall be affiliated . . . with any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities . . . ."

Because Applicants propose that certain of their officers and directors will also be officers and directors of the underwriting subsidiaries, the proposal raises an issue under section 32 of the Glass-Steagall Act (12 U.S.C. § (78) which provides that:

> No officer, director, or employee of any corporation . . . primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities shall serve [at] the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.

7 *See Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 207, 216 (1984) (hereinafter "Schwab").

Bankers Trust New York Corporation ("*Bankers Trust*") to engage in the placement of commercial paper issued by third parties as one activity of a commercial lending affiliate.[8] In that decision, the Board concluded that the placement activity involved did not constitute underwriting, distributing, or the public sale of securities for purposes of section 20. The Board further concluded that, even assuming this activity is covered by section 20, the term "engaged principally" in section 20 of the Glass-Steagall Act would allow the activity in an affiliate of a member bank if it is relatively insubstantial in terms of the total activity of the affiliate and the size of the market. Specifically, the Board cited the fact that since the gross revenues generated by the commercial paper activities of the affiliate would be no more than 5 percent of the affiliate's total gross revenues and that the affiliate's share of the total market for dealer placed commercial paper would not exceed 5 percent, the proposal would not violate section 20. In addition, the Board established a number of conditions to assure that the conduct of the activity was consistent with safe and sound banking practices and avoided conflicts of interest, concentration of resources, and other adverse effects. The Board applied this same framework of analysis in approving, on March 18, 1987, an application by The Chase Manhattan Corporation ("Chase") to engage in underwriting and dealing in commercial paper in a commercial finance subsidiary of the parent bank holding company.[9] The Board has been guided by these two decisions in deciding the applications now before the Board.

An index to this decision is contained in Appendix A to this Order.

Part I. Introduction & Summary of Findings

These applications raise fundamental questions concerning the scope of the Glass-Steagall Act's restrictions on the securities activities of member bank affiliates. Their resolution re-

8 73 FEDERAL RESERVE BULLETIN 138 (1987).

9 The Chase Manhattan Corporation, 73 Federal Reserve Bulletin 367 (Order dated March 18, 1987).

quires application of a statute adopted over 50 years ago in very different circumstances to a financial services marketplace that technology and other competitive forces have altered in a manner and to an extent never envisioned by the enacting Congress. Applicants' member bank affiliates seek to activate until now dormant provisions in section 20 of the Glass-Steagall Act to participate in underwriting and dealing in certain securities, so long as they are not engaged principally in this activity.

In its evaluation of the issues raised by the applications, the Board has been guided, as it must, by the terms of the statute and the underlying Congressional intent and purposes of the Act as evident in its structure and legislative history. Thus, the Board fully recognizes that Congress, through the Glass-Steagall Act, intended to separate commercial banks from general securities underwriting firms. Both the Board and the federal courts have often articulated the potential dangers to commercial banks from general underwriting activities that motivated the Congress in enacting the Glass-Steagall Act. The Board remains fully sensitive to these concerns.

Nevertheless, despite these dangers, the Congress drew a clear distinction between member banks and their affiliates in the Glass-Steagall Act. Except for certain specifically enumerated securities, including government securities, member banks were prohibited under the Glass-Steagall Act from engaging in any underwriting whatsoever. Member bank affiliates, on the other hand, were given a different statutory treatment under section 20 of the Act.

Member bank affiliates are permitted to participate in otherwise impermissible securities underwriting so long as they are not "engaged principally" in this activity. While prior to this time, there apparently has been no incentive to test the meaning of this authorization, the Board is now asked to apply it to specific proposals to engage in certain underwriting activities. Thus, the Board's task is to apply this explicit Congressional authorization to the proposed activities, but in a manner that gives effect to the Congressional intent in adopting the Glass-Steagall Act. Because of the precedent-setting nature of these applications, the Board has given them careful attention, ex-

tending over a period in excess of a year, during which time the statutory language, the legislative history, and the implications of these proposals for banking organizations and the financial markets generally have been carefully analyzed by the Board on a number of occasions. In addition, the Board conducted a hearing before the Board members on these important issues.

For the reasons set out in its decisions in the *Bankers Trust* and *Chase* cases, the Board believes it is bound by the statutory language of section 20 to conclude that a member bank affiliate may underwrite and deal in the ineligible securities proposed in the applications, provided that this line of business does not constitute a principal or substantial activity for the affiliate. The Board reaffirms its conclusion in those cases that Congress intended that the "engaged principally" standard permit a level of otherwise impermissible underwriting activity in an affiliate that would not be quantitatively so substantial as to present a danger to affiliated banks. The Board believes that it is only on this basis—that the activity would be insubstantial—that Congress concluded that, despite the hazards from underwriting that caused it to ban banks from engaging in underwriting, this activity would be permissible for the affiliates of member banks.

The Board devoted a considerable effort to evaluation of the factors that should be used to determine the level of ineligible underwriting and dealing activity that would not exceed the substantiality threshold. Taking into account its precedent in the administration of the Glass-Steagall Act and the comments at the hearing on this issue, the Board again concluded that the principal factors that should be included in this judgment are gross revenue and market share. As explained in detail below, the Board believes that these factors are not susceptible to manipulation to increase artificially levels of activity and fairly reflect the amount of involvement of a bank affiliate in securities underwriting.

With respect to the appropriate quantitative level of ineligible activity permitted under section 20, the Board concludes that a member bank affiliate would not be substantially engaged in underwriting or dealing in ineligible securities if its gross reve-

nue from that activity does not exceed a range of between five to ten percent of its total gross revenues. The Board also believes that a similar range should apply to the market share test it believes is appropriate under section 20. This range was established by reference to the Board's interpretations of the "primarily engaged" standard in section 32 of the Glass-Steagall Act. As discussed below, under these interpretations, a company would not generally be considered engaged substantially in ineligible securities activity if its gross revenues from that activity did not exceed 5 percent of its total gross revenues. Where underwriting volume was not large in absolute terms, however, somewhat higher levels of revenue were permitted, but generally not greater than 10 percent of total gross revenues.

Applying this framework to the current applications, the Board came to the conclusion that, in view of the fact that the volume of ineligible securities activity projected by Applicants would be very large in absolute terms, the lower end of the permissible range, 5 percent, should determine whether Applicants' gross income or market share from ineligible activity would be substantial. The Board recognizes that this 5 percent threshold for measuring the concept of "engaged principally" is a conservative interpretation of the level of activity permitted by section 20. The Board believes that a conservative, step by step approach is merited in applying the provision of a statute that was intended to deal with a crisis in our banking system and that has not been extensively interpreted by the courts as applied to the applications now before the Board. In the light of experience, the Board will consider, not later than one year from the date of this Order, whether, under the framework established by the Board in this Order, somewhat higher levels of activity would be consistent with the Board's finding that underwriting and dealing in ineligible securities in an affiliate of a member bank is permissible so long as the level of this activity measured by gross revenue and market share is not substantial.

In addition, the three applications now before the Board raise an important issue that was not present in the *Bankers Trust* and *Chase* applications. In those two cases, the applicants proposed to place or underwrite commercial paper in a subsidiary

that was not engaged in securities underwriting activities at all. Here, the three Applicants propose to underwrite and deal in securities in a subsidiary that is otherwise engaged in underwriting and dealing in government securities and other securities that banks may underwrite and deal in pursuant to section 16 of the Glass-Steagall Act.

Thus, in the three pending applications the Board must consider whether underwriting U.S. government securities and other securities that a bank may underwrite pursuant to section 16 of the Glass-Steagall Act should be considered a permissible activity for the purposes of applying section 20 of the Glass-Steagall Act to the proposed underwriting subsidiaries. If underwriting these securities, and particularly U.S. government securities, is considered permissible under section 20, as it is under section 16, an affiliate engaged principally in these activities could be then less than principally engaged in underwriting the otherwise impermissible securities proposed in the applications, including commercial paper, mortgage-backed securities and municipal revenue bonds. The answer to this question has vital significance for bank holding companies seeking to underwrite and deal in ineligible securities. Because of the operation of the net capital rules established by the Securities and Exchange Commission for broker-dealers, as a practical matter it is not feasible for bank affiliates to underwrite and deal in ineligible securities, other than commercial paper, within the confines of section 20 unless the subsidiary in which this activity takes place is engaged principally in underwriting and dealing in eligible securities—essentially U.S. government securities.

The question as to whether underwriting and dealing in government securities is included within the prohibition of section 20 of the Glass-Steagall Act depends upon an analysis of the language of the statute, the intention of Congress and the Board's own practice in administering the Act. The Board decided, in December 1986, not to resolve this question until after a hearing had given the parties an opportunity to develop further the record on this matter.

In the light of these considerations, the Board has concluded that U.S. government and other securities specifically made eligible for underwriting and dealing by member banks in section 16 should not be viewed as the kind of activity proscribed by section 20. The Board took into account, first, the fact that the Board has previously decided that a member bank affiliate is not engaged principally in impermissible activities if its sole business is underwriting and dealing in U.S. government and other eligible securities.[10] Second, the Board considered that Congress did not intend to apply a more restrictive underwriting standard to member bank affiliates than it legislated for member banks themselves.

The Board's conclusion with respect to the content and meaning of the authorization of section 20 to member bank affiliates to be less than engaged principally in otherwise impermissible underwriting activities is all the more compelling because the Board has reached the conclusion that the activities proposed in these applications can be conducted by bank affiliates on a safe and sound basis and without undue risk to affiliated banks. On the contrary, the evidence seems to indicate that without this authority banking organizations will be at a disadvantage in the competition to supply the credit needs of the most creditworthy borrowers with access to the less costly commercial paper market, with a consequent continuing decline in the overall quality of bank loan portfolios.

The Board has also evaluated whether the activities proposed in the applications are closely related to banking and a proper incident thereto under section 4(c)(8) of the BHC Act. 12 U.S.C. § 1843(c)(8). As stated in detail below, the Board has concluded that, because of the considerable experience of banks in underwriting and dealing in eligible securities, which are closely analogous to the proposed ineligible securities activities, and because the proposed commercial paper activities are functionally equivalent to traditional commercial banking functions, banking organizations are fully familiar with the proposed activities and have the expertise and capability to

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10 *See* 12 C.F.R. § 225.25(b)(16).

carry out the proposed functions. The Board also concluded that the proposed *de novo* participation in this activity would have the beneficial effect of substantially increasing competition, particularly in the highly concentrated commercial paper market, with the substantial expected public benefits of lowering financing costs as well as providing greater convenience to customers and increased efficiency in the proposed services.

As noted above, Congress recognized that a member bank affiliate that is not engaged principally in underwriting activities covered by section 20 could engage in otherwise impermissible securities underwriting even though it was aware that this activity could give rise to subtle hazards that could impair public confidence in depository institutions. The Board believes Congress was prepared to accept these risks because they could be contained within fully acceptable limits through maintaining the corporate separateness of the underwriting firm and the affiliated bank and through limitations on the relative size of the otherwise impermissible activities to assure their insubstantiality. These prudential limits have been fully implemented in the Board's interpretation of the Glass-Steagall Act.

In addition, other safeguards, both as a practical matter and under other statutory authorities, will be in place. As a practical matter, the securities which the Applicants propose to underwrite and the Board is prepared to authorize are securities that member banks are eligible to purchase for their own account, are of high quality and involve minimum risk. In terms of the statutory framework, the Board notes that bank holding company affiliates that engage in securities underwriting would be subject to SEC jurisdiction under the securities laws. Moreover, although not required by the Glass-Steagall Act, the Board believes it is appropriate to require that member bank affiliates underwriting otherwise impermissible securities observe a number of prudential considerations to assure capital adequacy and to limit both transactions and the flow of information between an underwriting subsidiary and other affiliates of the parent banking organization. These prudential considerations are explained in Part III below.

Accordingly, the Board has concluded that, subject to the limitations established in this Order, approval of each of the three applications would not result in a violation of the Glass-Steagall Act and would be consistent with the closely related and proper incident to banking standards of section 4(c)(8) of the Bank Holding Company Act.

Part II. Glass-Steagall Act

A. Applicants' Contentions

The Applicants contend that the underwriting subsidiaries would not be "engaged principally" in underwriting securities within the meaning of section 20 of the Glass-Steagall Act because the subsidiaries will limit the volume of their ineligible activity to a small percentage of their total business and so that the subsidiaries would not have a significant share of the market for any of the ineligible securities underwritten or dealt in.[11]

11 Citicorp proposes (in the third year and thereafter) to limit the total sales volume of underwriting by CSI in ineligible municipal revenue bonds, mortgage-related securities and CRRs to no more than 10 percent of all securities (both eligible and ineligible) underwritten by the affiliate during the previous year. Citicorp would similarly limit the affiliate's dealing in ineligible securities to 10 percent of its total securities dealing activity. Citicorp would also restrict the affiliate's underwriting of each type of security to no more than 3 percent of the total amount of each type of ineligible security underwritten domestically during the previous calendar year by all firms (mortgage-related securities and CRRs constitute a single category for this purpose). It would also limit the amount of each type of securities it may hold for dealing so as not to exceed this market cap.

Morgan proposes to limit ineligible underwriting and dealing activity by its affiliates (JPMS and JPMMF) in municipal revenue bonds, mortgage-related securities and commercial paper so that the activity will not, over any two-year period, account for more than 15 percent of the total consolidated eligible and ineligible securities activity of the affiliates as measured by two of the following three criteria: gross income, sales volume and average assets acquired in connection with the activity. Morgan would adopt the same market limitations as Citicorp, except that it proposes a 10 percent market share limitation for com-

The Applicants contend that the term "engaged principally" in section 20 means the chief or single largest activity, and that, therefore, their underwriting subsidiaries may underwrite and deal in ineligible securities so long as this ineligible activity does not constitute more than 50 percent of the subsidiaries' total business activity or represent its single largest business activity.[12] On this basis and subject to the proposed limitations on each subsidiary's ineligible securities underwriting and dealing activity, Applicants contend their underwriting subsidiaries would be "engaged principally" in underwriting and dealing in eligible securities, which is permissible under section 20, and, therefore, the subsidiaries could not by definition be engaged principally in underwriting ineligible securities in violation of section 20 of the Glass-Steagall Act. Applicants further claim that, even under the broadest reading of "principally" as denoting any substantial activity, their subsidiaries would not be engaged principally in ineligible securities activity under the limitations proposed in their applications.

Applicants also argue that the proposed dealing activities are not covered by section 20 of the Glass-Steagall Act, which they claim is limited to activities involving the initial distribution of securities. They base this claim on the fact that section 20 does not refer to "dealing" *per se*, but to the functions of issuance, flotation, underwriting, public sale, or distribution of securities.

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mercial paper based upon the average amount of dealer-placed commercial paper outstanding during the previous four calendar quarters.

Bankers Trust proposes to conduct, through its affiliate BTSC, ineligible underwriting and dealing activity involving municipal revenue bonds, commercial paper, and mortgage- and-consumer-receivable-related securities under the same tests as proposed by Morgan.

12 The Applicants rely on a dictionary definition of the term "principally" to mean the single largest activity and statements in the U.S. Supreme Court decision in ***Board of Governors of the Federal Reserve System*** v. ***Agnew***, 329 U.S. 441, 446, 448 (1947), concerning section 32 of the Glass-Steagall Act, which they argue indicate that "principally" as used in section 20 means more than 50 percent of the company's business.

B. Protestants' Comments

The protestants claim that Applicants' view of the term "principally" would vitiate the central purpose of the Glass-Steagall Act by allowing member banks to reestablish "security affiliates" that could rival the largest investment banking firms. For this reason, the protestants contend that the term "principally" must be interpreted consistent with Congressional intent to denote any substantial, significant, regular or non-incidental activity, whether or not it is the largest activity of the affiliate.

ICI further contends that the "engaged principally" standard of section 20 also would cover any company "formed for the purpose of" underwriting securities of any sort, the description of a securities company that was contained in the now repealed section 19(e) of the Glass-Steagall Act.[13] ICI contends that each of the underwriting subsidiaries was formed for the purpose of underwriting securities and thus, in its view, would be "engaged principally" in underwriting securities under section 20.

The protestants also contend that the terms "stocks, bonds debentures, notes, or other securities" in section 20 include all securities, both eligible and ineligible. Thus, they argue that, even under Applicants' interpretation of "engaged principally," the proposals to conduct ineligible securities activity in a government securities underwriting subsidiary would violate section 20 because the subsidiary's largest activity would be underwriting and dealing in "securities," albeit the preponderance of these securities would be bank-eligible U.S. government, state, and municipal securities.

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13 Banking Act of 1933, Pub. L. No. 66, § 19(e), 48 Stat. 162, 188 (codified at 12 U.S.C. § 61(e) (1964)), *repealed by* Act to Amend the Bank Holding Company Act of 1956, Pub. L. No. 89-485, § 13(c), 80 Stat. 236 (1966).

Section 19(e) prohibited a holding company affiliate, which was defined to include a bank holding company, from voting the shares of its subsidiary member bank if the holding company affiliate controlled, or participated in the management or direction of, any business organization "formed for the purpose of, or engaged principally in, the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds, debentures, notes, or other securities of any sort."

Applicants counter that the term "securities" in section 20 does not include government securities and other securities member banks are authorized to underwrite and deal in under section 16, on the theory that a member bank affiliate may engage in any activity authorized for the member bank under the Glass-Steagall Act.

C. Analysis of Glass-Steagall Act Issues

1. Securities that a Member Bank May Underwrite are not Covered by the Prohibition of Section 20.

Protestants contend that the term securities in section 20 encompasses all securities—both ineligible as well as bank eligible securities—and that, therefore, the proposed subsidiaries would be "engaged principally" in underwriting securities for purposes of section 20 even under Applicants' view of the term "principally."

The Board notes that, on its face, section 20 draws no distinction between eligible and ineligible securities, as is the case under other sections of the Glass-Steagall Act. The section simply contains a prohibition on a member bank's affiliation with any corporation engaged principally in underwriting "stocks, bonds, debentures, notes, or other securities."

Looking at the statute as a whole, however, the Board believes that Congress did not intend to include the eligible securities activity authorized for member banks under section 16 of the Glass-Steagall Act within the scope of section 20's prohibition against an affiliate's being engaged principally in the underwriting or public sale of "stocks, bonds, debentures, notes, or other securities." In the Board's view, the structure and Congressional intent of the Glass-Steagall Act make clear that in light of the express authorization in section 16 for member banks to underwrite eligible securities, the limitation of section 20 against a member bank affiliate being engaged principally in underwriting securities does not encompass bank eligible securities. In this regard, the Supreme Court has stated that the structure of the Glass-Steagall Act reveals a Congressional intent to impose a "less stringent standard" on member bank affiliates

under section 20 than is applied to the direct activities of member banks under section 16 of the Act[14] and that under the Glass-Steagall Act "a bank affiliate may engage in activities that would be impermissible for the bank itself."[15]

As section 16 expressly provides, and as was clear prior to its enactment, banks have the power to underwrite and deal in government obligations.[16] Given that section 20 establishes a less rigorous standard for member bank affiliates than is applicable to a member bank, it follows, *a fortiori*, that such bank eligible underwriting and dealing activity is permitted for a member bank affiliate. In reaching this conclusion, the Board has applied a fundamental principle of statutory construction that the various provisions of a statute should be construed as a whole and that a particular section of a statute may not be interpreted in isolation without regard to other sections of the statute of which it is a part.[17]

In accordance with this interpretation, the Board has for some time authorized bank holding companies, including those that controlled member banks, to establish subsidiaries to underwrite and deal in securities that are expressly authorized for member banks to underwrite and deal in under section 16,[18] and in 1984 authorized such activity for bank holding companies

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14 *Board of Governors of the Federal Reserve System* v. *Investment Company Institute*, 450 U.S. 46, 61 n.26 ("*ICI II*").

15 *ICI II*, 450 U.S. at 63-64.

16 2 F. Redlich, *The Molding of American Banking: Men and Ideas* 389 (1951); W. Peach, *The Security Affiliates of National Banks* 43-44 (1941).

17 *See United States* v. *Morton*, 467 U.S. 822, 828, *rehearing denied*, 468 U.S. 1226 (1984); *Philbrook* v. *Glodgett*, 421 U.S. 707, 713 (1975); *United Mine Workers of America* v. *Andrews*, 581 F.2d 888, 892 (D.C. Cir.), *cert. denied*, 439 U.S. 928 (1978). 2A Sutherland Statutory Construction § 46.05 (4th ed. 1984).

18 *United Bancorp*, 64 FEDERAL RESERVE BULLETIN 222 (1978); *Stepp, Inc.*, 64 FEDERAL RESERVE BULLETIN 223 (1978); *United Oklahoma Bankshares, Inc.*, 65 FEDERAL RESERVE BULLETIN 363 (1979); *Citicorp*, 68 FEDERAL RESERVE BULLETIN 249 (1982).

generally by regulation.[19] The Board's decision in these cases was premised upon its view that the conduct of such bank eligible securities activities by member bank affiliates is not the type of activity prohibited by section 20 or 32 of the Glass-Steagall Act.

The interpretation of section 20 urged by protestants that a member bank affiliate may not underwrite securities that are expressly authorized for a member bank itself not only runs counter to the Supreme Court's statements regarding the scope of section 20, but is also inconsistent with the fundamental purpose of the Glass-Steagall Act. The Glass-Steagall Act was enacted with one central purpose in mind, to protect bank depositors from the hazards that Congress viewed as attributable to the combination of commercial and investment banking. However, Congress did not view the traditional underwriting activities of banks in government securities as giving rise to these dangers to the bank and its depositors and on this basis permitted the continuation of that activity within the bank itself.[20]

Section 20 was designed to limit the scope of activities of member bank affiliates as a complement to the restrictions on banks' direct underwriting and dealing activities,[21] and as a means of enforcing the separation of commercial from investment banking.[22] Clearly, therefore, section 20 was not designed to prohibit affiliates from engaging in activity a bank could

19 12 C.F.R. § 225.25(b)(16). The Board notes that protestants did not challenge the Board's rule authorizing this activity for bank holding companies or any of its approvals for bank holding companies to engage in this activity.

20 *See ICI II*, 450 U.S. at 61-62.

21 The Senate Report on the bill that subsequently became the Glass-Steagall Act indicates that Congress was concerned with the fact that banks had formed affiliates to conduct activity "never contemplated by the National Banking Act." S. Rep. No. 77, 73d Cong., 1st Sess. 10 (1933). *Accord*: 75 Cong. Rec. 9887 (1932) (remarks of Sen. Glass) and 75 Cong. Rec. 9911 (1932) (remarks of Sen. Bulkley). *See also Investment Company Institute* v. *Camp*, 401 U.S. 617, 629 (1971) ("*ICI I*").

22 *See ICI II*, 450 U.S. at 61-62.

lawfully conduct.[23] Moreover, there is some evidence in the legislative history of the Glass-Steagall Act that section 20 was not meant to prohibit the underwriting of government securities. 76 Cong. Rec. 2000, 2274 (1933) (remarks of Sen. Long); 76 Cong. Rec. 1941 (1933) (remarks of Sen. Glass).

To read the statute otherwise would mean that Congress intended to impose a substantially stricter standard on an affiliate than on the member bank itself, an interpretation that would be out of harmony with the central purpose of the Act to protect the bank and its depositors. Moreover, with respect to the analogous question raised in *ICI II*, as to whether an activity could be prohibited under section 21 that was authorized under section 16, the Supreme Court stated that section 21 "surely was not intended to require banks to abandon an accepted banking practice that was subjected to regulation under section 16." 450 U.S. at 63. In affirming the Board's decision authorizing bank holding companies to act as discount brokers, the Court also noted that the fact that section 16 authorizes the activity for member banks suggested that it was not the type of activity at which the Glass-Steagall Act was aimed.[24]

Similarly, the United States Court of Appeals for the D.C. Circuit has recently stated that "those activities of commercial banks that section 16 places on the acceptable commercial banking side of the line [between commercial and investment banking] cannot be placed by section 21 on the impermissible investment banking side of the line."[25] Accordingly, the court concluded that section 21 of the Glass-Steagall Act would not prohibit a bank from selling securities to the extent authorized for member banks under section 16, even before the amendment to section 21 in 1935 excepting from section 21's prohibition activities authorized for member banks under section 16.

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23 *Id.*

24 *Schwab*, 468 U.S. at 221.

25 *Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 807 F.2d 1052, 1058 (D.C. Cir. 1987), *petition for cert. pending* No. 86-1429 ("*Bankers Trust II*").

The court reached this conclusion on two separate and independent grounds, both of which, in the Board's view, support the conclusion that section 20 does not cover activity authorized under section 16. First, the court noted, as Applicants point out, that the 1935 Amendment to section 21 was termed a clarifying amendment "to make it clear that [section 21] does not prohibit any financial institution or private banker from engaging in the securities business to the limited extent permitted to national banks under [section 16]."[26] This the court felt necessarily implied that the authorization under section 16 also applied to the prohibition of section 21 against selling and underwriting securities generally, even before the 1935 amendment. Second, the court noted that, unless the authorization of section 16 was read as an exception to section 21, a member bank would be prohibited by section 21 from conducting activities the bank was expressly authorized to conduct under section 16, a result the court termed absurd. *Id.* at 1058.

The Board believes this reasoning is directly applicable to section 20, which by its terms covers the same types of securities and the same underwriting and selling activities described in section 21. Thus, in order to avoid the illogic of barring a member bank affiliate from activity expressly authorized for the member bank, the Board believes that section 20 must necessarily not cover securities activity authorized for member banks under section 16.[27] Moreover, given the fact that Congress has

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26 H. Rep. No. 742, 74th Cong., 1st Sess. 16 (1935). Relying on the legislative history, the court in *Bankers Trust II* said the 1935 amendment to section 21 was "simply to leave no doubt of the need to read the two sections [16 and 21] harmoniously. . . ." 807 F.2d at 1058.

27 The SIA claims that an interpretation of section 20 that prohibits a bank affiliate from underwriting and dealing in even eligible securities is not unreasonable because Congress may have intended the underwriting of government securities to be conducted directly by the bank—a federally regulated entity. Such an explanation is implausible, in the Board's view, because when Congress undertook to regulate broker-dealers generally shortly after passage of the Glass-Steagall Act, companies dealing only in government securities were expressly exempted from federal regulation. Thus, any company that underwrote only government securities would not have been subject to federal regulation.

legislated a less stringent standard for member bank affiliates than for banks and that Congress, as the court concludes, did not intend section 21 even before its amendment to bar member banks from activity authorized under section 16, it follows that Congress must necessarily have intended not to bar their affiliates from such activity.[28]

Finally, the Board notes that the limited expansion of the activities of Applicants' government securities subsidiaries, as proposed in the applications and limited by this Order, would not transform these subsidiaries, which would derive substantially all of their income from permissible eligible underwriting activities and would not engage in a full investment banking business, into the type of general securities underwriting affiliates Congress intended to divorce from member banks in 1933.

Since eligible securities cannot reasonably be viewed as securities for purposes of section 20, member bank affiliates that conduct such eligible securities underwriting activity cannot be viewed as engaged in the securities underwriting business proscribed by section 20 and thus may—as may any other member

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28 Protestants contend that the failure of Congress to amend section 20 in 1935 to permit member bank affiliates to underwrite securities authorized under section 16 demonstrates member bank affiliates were not intended to be permitted to conduct such activity. The Board, however, believes that the better view is that articulated in *Bankers Trust II* that the 1935 amendment merely clarified the preexisting state of affairs and that, just as banks were not prohibited by section 21 from engaging in activity permitted under section 16 even before the amendment, member bank affiliates must necessarily not have been prohibited from engaging in such activity under section 20. Thus, Congress' failure to amend section 20 in 1935 does not mean that Congress intended to bar member bank affiliates from activity permitted for member banks. Moreover, it was necessary to clarify section 21 because it is a criminal statute and the Attorney General had expressed the view with respect to certain aspects of section 21 that clarification would be desirable. *Banking Act of 1935: Hearings on S. 1715 and H.R. 7617 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 74th Cong., 1st Sess. 139-140 (1935) (Testimony of J.F.T. O'Connor). Section 20, however, is not a criminal statute and in light of the Board's ability to issue interpretations of that statute, there was no pressing need for clarification, as was the case with section 21.

bank affiliate—engage in ineligible underwriting and dealing activity where such activity is not a principal line of business for the affiliate. In the Board's view, there is no basis in the terms or legislative intent of section 20 to prohibit an eligible securities underwriting subsidiary from underwriting and dealing in any ineligible securities activity while allowing a subsidiary engaged in commercial finance, mortgage banking, securities brokerage or other nonbanking activity permissible for bank holding companies to engage to some extent in ineligible securities activities.

In this regard, the Board has considered the proposed limited expansion of Applicants' government securities subsidiaries' activities in light of the hazards to the bank and its customers that the Glass-Steagall Act is intended to prevent. As noted, Congress clearly did not view the underwriting of bank-eligible securities as harmful to the bank or its depositors and Congress plainly permitted ineligible underwriting activity so long as it did not amount to a principal activity. Moreover, as noted, the Board's order in this case goes further than Congress under the Glass-Steagall Act and establishes limitations on the conduct of the activity under the Bank Holding Company Act to assure that the activity will not produce significant conflicts of interest, unsound banking practices, unfair or decreased competition, undue concentration of resources or other adverse effects.[29]

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29 In its evaluation of this case, the Board has carefully considered the fact that Applicants' underwriting subsidiaries were formed in major part through the transfer to the subsidiaries of government securities activities previously conducted as departments or divisions of the Applicants' member bank subsidiaries. As indicated, the Board has previously approved the transfer of such activities to the holding companies' underwriting subsidiaries as a permissible nonbanking activity under the BHC Act. Accordingly, the Applicants are engaged in this activity pursuant to law and regulatory authorization. While the transfer of these functions could result in the deliberate creation of a large base of eligible activity, the size of the ineligible activity that may be conducted by these affiliates is sharply limited by the "engaged principally" provisions of the Glass-Steagall Act as interpreted by the

For the above reasons, the Board believes that the term "securities" in section 20 must be read as not including those securities that member banks are expressly authorized to underwrite and deal in under section 16.

2. Dealing Constitutes the Underwriting or Public Sale of Securities Under Section 20.

Applicants maintain that "dealing" is not an activity covered by the terms "issue, flotation, underwriting, public sale, or distribution" in section 20, particularly if dealing is limited only to secondary market sales and does not involve an initial distribution of securities. For the reasons set out below and more fully in the attached Appendix B, the Board concludes that the securities activity covered by section 20 is not limited to the initial distribution of securities, but also includes the activity of holding oneself out to the public as being willing to buy and sell securities as a principal in the secondary market, or "dealing" as that term is used by the Applicants. This conclusion is consistent with the literal meaning of the term "public sale" in section 20, the legislative history of the section, judicial interpretation, the purposes of the Act, and the Board's longstanding practice.

Literally, the term "public sale" in section 20 is broad enough to encompass dealing in securities. A dealer commonly refers to a person who holds himself out to the public as being willing to buy and sell securities for its own account. 2 L. Loss, *Securities Regulation* 1215, 1297 (2d ed. 1961). Moreover, the legislative history of the Glass-Steagall Act indicates that Congress intended to cover not only underwriting activity but also stock speculation, market making and participation in trading

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Board. As discussed below, these provisions involve the concept of a quantitative limitation on underwriting activity which is embodied in the income and market share criteria for establishing "substantiality" contained in this Order. The Board wishes to stress that the latter criterion, in particular, creates a limitation on underwriting activity which is independent of the size of the affiliate that might be established by purposeful transfer of activities from the bank to the underwriting affiliate.

pools—activities attributable to dealing and not generally associated with initial distribution activities.[30]

On this basis, the Board for many years has consistently ruled that dealing is covered by section 32 of the Act, which, as noted, is identical to section 20 in terms of its coverage of issuance, flotation, underwriting, public sale, or distribution activities.[31]

The conclusion that dealing constitutes the "public sale" of securities under section 20 is also supported by the Supreme Court's observation in *Schwab*, 468 U.S. at 217-18, that the activities described in section 20 refer, at a minimum, to operations in which the affiliate acts as a principal.

3. The Term "Engaged Principally" in Section 20 Denotes any Substantial Activity.

In its *Bankers Trust* decision, the Board concluded that, even if the placement as agent of commercial paper were deemed to constitute an activity covered by section 20 of the Glass-Steagall Act, Bankers Trust's commercial lending affiliate would not be "engaged principally" in underwriting or dealing in securities within the meaning of section 20 under the 5 percent income and market share limits at issue in that case. The Board held that the term "engaged principally" in section 20 denotes any activity of the underwriting affiliate that is substantial, even if

30 *See* S. Rep. No. 77, 73d Cong., 1st Sess. 10 (1933). *See also Operation of the National and Federal Reserve Banking Systems, 1931: Hearings on S. Res. 71 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 71st Cong., 3d Sess. 198-199, 306-309, 1063-1064. The conclusion that section 20 covers dealing is also more consistent with the purposes of the Glass-Steagall Act to address the Congress' concern over the "subtle hazards" of a bank having a pecuniary interest in the purchase and sale of particular securities. *ICI I*, 401 U.S. at 629-34; *Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 137, 145 (1984) ("*Bankers Trust I*"); *Schwab*, 468 U.S. at 220.

31 20 FEDERAL RESERVE BULLETIN 393 (1934); 20 FEDERAL RESERVE BULLETIN 750 (1934); 51 FEDERAL RESERVE BULLETIN 810 (1965); 12 C.F.R. § 218.110(d).

the activity does not represent more than 50 percent of the affiliate's total business activity or its single largest or most important activity. A similar decision was made in the *Chase* case.

After considering the submissions by the parties and other interested persons at the hearing and in post-hearing materials, the Board continues to be of the view, for the reasons expressed in full in *Bankers Trust*, that the term "engaged principally" in section 20 denotes any substantial activity of the affiliate.

In this regard, the Board has considered the argument by ICI regarding the now repealed section 19(e) of the Glass-Steagall Act. While section 19(e) and section 20 were designed to accomplish the same general objective and overlap to some extent in the case of a securities company affiliated with a member bank within a bank holding company system, section 20 does not contain the "formed for the purpose of" language found in section 19(e).

Moreover, nothing in the legislative history of the Glass-Steagall Act or the 1966 legislation which repealed section 19(e) indicates that the "engaged principally" standard of section 20 incorporated the "formed for the purpose of" standard. Section 19(e) was repealed, at the recommendation of the Board, because it was "doubtful" whether section 19(e) was "sufficiently useful" to justify its retention in light of the enactment of the Bank Holding Company Act.[32]

The Board has also considered the Supreme Court's discussion of section 19(e) in *ICI II*, 450 U.S. at 70 n.43. In the Board's view, the Court's statements merely reflect the view that if a company is formed in order to underwrite securities, one would expect the company to be "engaged principally" in that activity. The Court was not presented with a situation, such as that presented here, in which the company's largest activity is permissible government securities underwriting activities and its ineligible activities are insubstantial. In this regard, the Board is unaware of any instance of a member bank affili-

32 S. Rep. No. 1179, 89th Cong., 2d Sess. 12 (1966); *Bank Holding Company Act, Report of the Board of Governors of the Federal Reserve System to the Comm. on Banking and Currency, U.S. Senate*, 85th Cong., 2d Sess. 26 (Comm. Print 1958).

ated in a bank holding company system with a securities company that was covered by the "formed for the purpose of" language of section 19(e), but not by "engaged principally" language.

Finally, the Board notes that the "formed for the purpose of" language—like the "engaged principally" terminology in section 20—is susceptible to different meanings. For example, the "formed for the purpose of" language could be construed to refer to the situation where the company was specifically formed to underwrite ineligible securities and would not cover the situation where the company was formed for the purpose of commercial finance (as in the *Bankers Trust* and *Chase* cases previously approved by the Board) or to underwrite bank-eligible securities as in these cases.

Nevertheless, while the Board does not believe the "formed for the purpose of" standard has been incorporated in the "engaged principally" standard of section 20, the Board does note that section 19(e), because of its overlap with and close relationship to section 20, does tend to confirm the Board's conclusion that the "engaged principally" standard of section 20 must be read to cover any substantial ineligible activity of the affiliate in order to carry out Congressional intent to separate member banks from securities affiliates.

The Board has also considered Applicants' contention, reiterated at the hearing and in post-hearing materials, that the Board is required by the Supreme Court's *Agnew* decision to determine that the "engaged principally" standard of section 20 denotes only that activity of the affiliate that constitutes more than 50 percent of its total business activity or its single largest activity. The Board has carefully considered Applicants' position, but remains of the view that the Supreme Court in the *Agnew* case does not determine dispositively the meaning of "engaged principally" in section 20. As the Board noted in its *Bankers Trust* Order, section 20 was not at issue in *Agnew* because of the absence of a stockholder affiliation between the member bank and the securities company involved. 73 FEDERAL RESERVE BULLETIN 143, 144 (1987). Nor was any such determination necessary to the Court's decision regarding the

term "primarily engaged" in section 32, since even if the Court determined that the two standards were identical, it would not have been precluded from reaching the same conclusion—that "primarily" meant any substantial activity, given that "principally" can also mean any substantial activity. As was explained in the *Bankers Trust* Order, at the time the Glass-Steagall Act was passed, an accepted dictionary definition of principally included "important" and "primarily."

As noted in *Bankers Trust*, the Board believes its conclusion regarding the meaning of section 20 is particularly appropriate in light of the fact that to hold otherwise would mean that section 20 would apply to no one, since investment banking firms typically engage in numerous other activities in addition to securities underwriting and dealing. This rationale led the Court in *Agnew* to affirm the Board's interpretation that section 32 denoted any substantial activity. Indeed, such a view would permit member banks to establish the very affiliations with the nation's largest investment banking businesses that section 20 was precisely designed to prohibit.[33]

At the hearing, Applicants also disputed the Board's conclusion that common sense would suggest that Congress could not have intended to apply a less stringent standard where a member bank and an underwriter were affiliated through common stock ownership than was applied where a member bank and an

33 In order to support its strict interpretation of section 32, the *Agnew* Court observed that the Act distinguished between firms primarily engaged and engaged principally in underwriting. 329 U.S. at 448. In the Board's view, the *Agnew* Court reached its decision on the meaning of "primarily engaged" on the basis of the terms and legislative intent of the statute. 329 U.S. at 447. Its subsequent references in the opinion to "principally" in section 20 were clearly meant to bolster its decision made on the basis of the terms and legislative intent of the statute. While the Court's observation is a part of the Court's reasoning, it is not a legally binding ruling on the scope of section 20. In addition, in the Board's view, the Court's supplemental argumentation should not be accorded controlling weight here, given that the Court in *Agnew* had no occasion to consider the fact that viewing "principally" to mean the chief or single largest activity would produce results that are inconsistent with what the Court understood to be the basic purpose of the legislation.

unaffiliated underwriter merely shared a common director. In *Bankers Trust*, the Board pointed out that Applicants' view of principally would mean that a member bank could be affiliated through common stock ownership with a securities company substantially but not predominantly engaged in underwriting, but could not establish a single management interlock with the company, a seemingly anomalous result in light of the greater potential in common ownership situations for adverse effects of the type that led Congress to enact the Glass-Steagall Act.[34] Applicants contend that Congress in fact intended to apply a more lenient standard in common ownership situations because the securities affiliate of a member bank would be subject to examination and rules limiting transactions between the member bank and its affiliates.

At the outset, the Board notes that there is nothing in the legislative history to support Applicants' view. Moreover, the Supreme Court has stated that Congress in 1933 rejected the view that examination and regulation of bank securities affiliates would address the concerns Congress perceived when commercial and investment banking functions are combined. *Bankers Trust I*, 468 U.S. at 147. Rather, Congress felt that most commercial and investment banking functions were "fundamentally incompatible." *Id.* The Board also notes that the examination authority and affiliate transaction restrictions contained in the Glass-Steagall Act were not comprehensive and did not foreclose the possibility of the type of adverse effects that concerned Congress and resulted in enactment of the Glass-Steagall Act. For example, section 23A of the Federal Reserve Act,[35] to which Applicants point, did not apply to purchases of assets by a member bank from an affiliate until 1982, thus allowing dumping of securities in a member bank or the purchase by a member bank of low quality assets from a securi-

34 73 FEDERAL RESERVE BULLETIN at 143, 144.

35 Banking Act of 1933, Pub. L. No. 66, § 13, 48 Stat. 162, 183 (codified at 12 U.S.C. 371c (1976), *amended by* Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, § 410, 96 Stat. 1469, 1515.

ties affiliate, a hazard Congress was specifically concerned with in 1933.

APPROPRIATE MEASURES OF "ENGAGED PRINCIPALLY"

Having determined that the "engaged principally" standard of section 20 denotes any substantial activity, the Board must determine whether, under the limitations proposed by the Applicants, their subsidiaries' ineligible underwriting and dealing activity would be substantial. In making this determination, the Board has been guided by the Congressional intent underlying section 20 of the Glass-Steagall Act to insulate member banks from the dangers Congress associated with the combination of commercial and investment banking by allowing member bank affiliates to underwrite and deal in ineligible securities only at a level that would not be substantial. Taking these factors into account in the *Bankers Trust* and *Chase* cases, the Board determined that where ineligible activity would not exceed 5 percent of the affiliate's gross revenues or 5 percent of the market for the type of security being placed or underwritten, the activity would not be substantial.

Applicants have suggested a number of differing methods for determining when an affiliate is "engaged principally" in underwriting activity, including limitations based on sales volume alone or on sales volume, assets devoted to the activity or income on a two out of three basis. The Board, however, continues to believe that the most appropriate measure of "engaged principally" is the gross revenue the affiliate derives from the ineligible underwriting and dealing activity relative to the revenue derived from its total business activities. This is consistent with the Board's practice under the "primarily engaged" standard of section 32 of the Glass-Steagall Act, which gives substantial weight to the size of the company's revenue from underwriting activity relative to its total revenue.[36] In addition, the Board believes it appropriate to consider the signifi-

36 Letter from the Board to the Federal Reserve Banks (August 11, 1958), *reprinted in Federal Reserve Regulatory Service* ("F.R.R.S."), ¶ 3-895.

cance of the organization's presence in the market for the particular activity, also a factor considered by the Board in prior rulings under the Glass-Steagall Act.[37]

As noted in the *Bankers Trust* Order, the Board believes that gross revenue is the appropriate test to determine whether a subsidiary is "engaged principally" because it is an objective and meaningful measure of the importance of the activity to the subsidiary as a whole and also reflects the level of risk involved in the activity, a major consideration behind enactment of the Glass-Steagall Act. In addition, a gross revenue test goes some way toward avoiding the potential for manipulation present in a test based solely on sales volume. Although gross revenues may be influenced to enlarge ineligible operations, the sales volume of a government securities subsidiary could be easily inflated by daily "matched book" operations[38] or be increased through churning of the affiliate's dealing activity in permissible securities in order to create a larger base against which ineligible activity would not appear to be substantial. The Board also notes that the average assets test suggested would not take into account ineligible underwriting activities which do not entail substantial or lengthy investment of the underwriting subsidiary's own funds.[39]

The Board has considered Applicants' comments at the hearing regarding the desirability of their proposed tests, including their view that the volume tests would not be subject to artificial increases because of increased costs and legal constraints. The

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37 *Id.*

38 Matched book activities would consist of repurchase and reverse repurchase agreements for government securities, used by dealers and their financial institutions customers for short term funding, hedging and arbitrage. As government securities dealers, Applicants' subsidiaries would have a high volume of such activity.

39 Bankers Trust's and Morgan's reliance on tests based on assets devoted to the activity, income and sales volume, on a "two out of three" basis, are similarly flawed because an affiliate could derive a substantial amount of its income from ineligible activity even though the ineligible activity met the asset and sales volume test, both of which, in the Board's judgment, would be open to increasing the base of eligible activity to support ineligible activity.

Board, however, continues to be of the view that a revenue test is the best overall measure under section 20, posing the fewest operational difficulties and giving the most accurate indication of the importance of the activity to the affiliate's total business operations. While Applicants argue there are a variety of different tests that could be applied to measure engaged principally status and that the tests should be tailored for each applicant, the Board believes that a uniform standard measure is desirable to assure a rule that would be simple to apply and enforce and to avoid unfairness in application among various applicants.

The Board also believes that in determining whether a company's underwriting activity is substantial it is important to consider in connection with gross revenue the affiliate's market share for the particular type of security underwritten. In the Board's judgment, the fact that an affiliate would be a major force in a particular securities market would be an evidentiary factor suggesting that the affiliate is "engaged principally" in underwriting securities. Thus, the Board has taken into account a firm's market share in decisions under the Glass-Steagall Act, particularly as it is related to the scope and extent of the firm's ineligible activity.[40]

In addition, the Board believes that a market share test would provide a useful and objective proxy for sales volume, which the Board believes is an important factor to be taken into account under the engaged principally test of section 20, and which the Board has considered in its decisions under section 32. Unlike the test based on sales volume of the subsidiary, the market share test would not be subject to manipulation, but would provide for consideration of the volume of business activity of the affiliate in absolute terms.[41]

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40 Letter from the Board to the Federal Reserve Banks (August 11, 1958) F.R.R.S. ¶ 3-895. *See also*, *e.g.*, Board letter dated September 30, 1947.

41 Applicants and the Antitrust Division of the Department of Justice argue that the Board is precluded from considering market share information in applying section 20, noting that the "engaged principally"

Finally, the Board believes that any decision regarding engaged principally status should take into account other factors and circumstances present in the pending applications. In the instant cases, the Board believes it significant that each of the three underwriting subsidiaries will maintain their fundamental nature as government securities dealers. They will underwrite a limited range of securities that are closely analogous to securities presently underwritten by member banks or to commercial banking functions, and at levels that would not be substantial relative to their eligible securities activities. Thus, the proposed limited expansion would not transform the government securities dealers into the type of securities affiliates engaged in the general investment banking and securities underwriting business that Congress intended to separate from member banks through section 20.

QUANTITATIVE LEVEL OF ACTIVITY PERMITTED UNDER SECTION 20

With respect to the appropriate quantitative level of activity permissible under the section 20 authorization, the Board has determined that a member bank affiliate would not be engaged principally or substantially in underwriting or dealing activity covered by section 20 if its gross revenue from that activity does not exceed a range of between 5 and 10 percent of its total gross revenues. The Board believes a similar range should apply to the market share test the Board has adopted under section 20.

The Board established this range by reference to the Board's past practice for many years in interpreting the "primarily engaged" standard in section 32, which, as noted, covers any substantial underwriting and dealing activity. This approach is, in the Board's judgment, consistent with the Congressional intent underlying section 20 to allow member bank affiliates to engage

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terminology focuses on the relative amount of activity within a particular company. However, the Board is not relying on market share information *per se*, but as a qualitative factor and as a substitute for a volume test, which is related solely to the activities of a particular affiliate but which the Board believes, in the context of these proposals, is not a reliable measurement criterion alone.

in underwriting and dealing activities at levels that are not substantial and thus would not raise problems of safety or soundness or risk for affiliated member banks.

In a number of cases over the years, the Board has developed a general guideline that a company would not be primarily or substantially engaged in activities covered by section 32 where those activities accounted for no more than 10 percent of the company's total revenue and the company's volume of such activities was not large in absolute terms or relative to other market participants.[42] If the firm was a leading securities underwriter with a large absolute volume of ineligible securities activities, however, the Board has found the firm to be primarily engaged in section 32 activities where the revenue the firm derived from these activities was between 5 and 10 percent of its total gross revenue.[43] Generally, where gross revenues from ineligible activity were less than 5 percent, the Board has not found the securities company to be primarily or substantially engaged in ineligible activity.[44]

In applying these principles to the present proposals, the Board notes that the volume of ineligible securities activity projected by Applicants could be large in absolute terms, and under their projections Applicants could be a substantial factor in the markets they propose to enter. Accordingly, the Board believes that the lower 5 percent end of the permissible range of activity under section 20 is the appropriate quantitative level for applying the gross revenue and market share tests to these proposals. The Board recognizes that this 5 percent threshold for gross income and market share represents a conservative approach to measuring the level of ineligible underwriting and dealing wthin the framework established by this Order and the Board's prior decisions under section 32. The Board will review

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42 Letter, dated December 14, 1981, *reprinted* in F.R.R.S. ¶ 3-939, and Board letter dated May 6, 1953.

43 *Id.* and, *e.g.*, Board letters, dated May 12 and June 22, 1954, May 22, 1959, *reprinted in* F.R.R.S. ¶ 3-896.

44 *E.g.*, Board letters, dated May 5, 1934 and May 7, 1962.

this determination, within one year, after Applicants have gained some experience in operating the proposed underwriting subsidiaries, to assess whether somewhat higher levels of activity up to 10 percent may be permissible consistent with the Board's interpretation of the term engaged principally as encompassing any activity that is substantial.

Applicants contend that the activity permitted under their proposed 10 to 15 percent of activity tests would not be substantial in the context of a government securities subsidiary that would derive 85 to 90 percent or more of activity from permissible activities under their standards for measurement. However, as noted above, the Board has carefully considered the standards and quantitative measures for determining whether an affiliate would be "engaged principally" under the provisions of section 20. The quantitative standards proposed by Applicants exceed the levels which the Board believes represent an appropriate interpretation of the provisions of section 20 that is consistent with both its language and the intention of Congress. In the Board's judgment, at the levels proposed by Applicants, the proposed affiliates would be clearly engaged principally in underwriting and dealing in securities.

In sum, the Board will not consider the underwriting subsidiaries to be engaged principally in ineligible underwriting and dealing activities under section 20 of the Glass-Steagall Act under the conditions established below for the conduct of the activity under the BHC Act, if

(1) the underwriting subsidiaries derive no more than 5 percent of their total gross revenues from ineligible underwriting and dealing activity on average over any two year period,

(2) their underwriting activities in connection with each particular type of ineligible security do not account for more than 5 percent of the total amount of that type of security underwritten domestically by all firms (or, in the case of commercial paper, the average amount of dealer-placed commercial paper outstanding) during the previous calendar year, and

(3) they limit the amount of each particular type of security held for dealing so as not to exceed the amount of the underwriting market share limitation described in paragraph (2) above.[45]

4. Proposed Interlocks Between Applicants' and Their Underwriting Subsidiaries are not Prohibited by Section 32.

Applicants anticipate that one or more officers of the bank holding company will serve as officers or directors of the subsidiaries that would conduct the proposed limited underwriting and dealing activity. The Board has previously applied the restrictions of section 32 to interlocking relationships between a securities firm and a bank holding company with one or more member bank subsidiaries. 12 C.F.R. § 218.114; F.R.R.S. ¶ 3-912. *See also* F.R.R.S. ¶ 3-948. The Board, however, has permitted an interlocking relationship between a securities firm and a bank holding company that mainly conducted nonbanking activities. F.R.R.S. ¶ 3-889.

In this case, the proposed interlocking relationships between the parent bank holding company and the underwriting subsidiaries would be permissible under section 32 because, even if it is assumed that the restrictions of section 32 should be applied to the parent holding company, under the limitations discussed above on the level of ineligible activity permitted to the subsidiaries, they would not be "substantially" or "primarily engaged" in ineligible activity.

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45 J.P. Morgan proposed to measure the amount of ineligible activity it would conduct through JPMS and JPMMF on a consolidated basis. Under that proposal, the total gross income from eligible and ineligible activity of both entities would be combined for purposes of the section 20 "engaged principally" limitation. The Board does not believe that section 20 permits two or more affiliates to combine their ineligible and eligible activity in order to determine whether as a whole the affiliates would be "engaged principally." By its terms, section 20 applies to each individual company affiliated with a member bank. Thus, JPMS and JPMMF each must adhere to the section 20 limitation.

None of the Applicants has proposed that an officer, director, or employee of its bank affiliates serve as an officer, director, or employee of the underwriting subsidiaries and, as discussed in Part III below, the Board has relied upon the absence of such interlocking relationships in its evaluation of the applications under the proper incident to banking standard of section 4(c)(8) of the BHC Act.

Part III. Bank Holding Company Act Analysis

In every application under section 4(c)(8) of the Bank Holding Company Act, the Board must find that the proposed activity is "so closely related to banking . . . as to be a proper incident thereto." This statutory standard requires that two separate tests be met for an activity to be permissible for a bank holding company. First, the Board must determine that the activity is, as a general matter, "closely related to banking." Second, the Board must find in a particular case that the performance of the activity by the applicant bank holding company may reasonably be expected to produce public benefits that outweigh possible adverse effects.[46]

Based on guidelines established in *National Courier Association* v. *Board of Governors of the Federal Reserve System*, 516 F.2d 1229, 1237 (D.C. Cir. 1975), a particular activity may be found to meet the "closely related to banking" test if it is demonstrated that:

(1) banks generally have in fact provided the proposed activity;

(2) banks generally provide services that are operationally or functionally so similar to the proposed activity so as to equip them particularly well to provide the proposed activity; or

(3) banks generally provide services that are so integrally related to the proposed activity as to require their provision in a specialized form.

46 *See Schwab*, 468 U.S. at 210; *ICI II*, 450 U.S. at 57 n.22.

The *National Courier* guidelines are not, however, the exclusive basis for finding a proposed activity closely related to banking,[47] and the Board may consider any other basis that may demonstrate that the activity has a reasonable or close relationship to banking. 49 *Federal Register* 806 (1984). The U.S. Supreme Court stated in *Schwab* that the use of these factors by the Board in determining the closely-relatedness of an activity is reasonable and within the Board's discretion. 468 U.S. at 210 n.5, 214.

As a threshold matter, Citicorp and certain other commenters argue that the fact that these proposals are consistent with section 20 represents a Congressional determination that they are permissible for bank holding companies, a determination that may not be limited or revised under section 4(c)(8). This argument is premised on the Supreme Court's observation in *ICI II* that the BHC Act does not impose restrictions on the securities activities of banking institutions that are more severe than those in the Glass-Steagall Act. 450 U.S. at 60-61 n.26.

In the Board's view, however, the restrictions of the Glass-Steagall Act on the securities activities of member bank affiliates and the closely related to banking and proper incident to banking tests in section 4(c)(8) are by their terms independent provisions, each of which must be satisfied before a bank holding company may engage in securities activities. The *ICI II* opinion, the Board believes, supports this analysis.

In *ICI II*, the lower court had ruled that the BHC Act was intended to prohibit the Board from approving any securities activities for bank holding companies, even if they were permissible under the Glass-Steagall Act. The Supreme Court rejected this ruling, finding no implicit prohibition in section 4(c)(8) that is more restrictive than the Glass-Steagall Act.[48]

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47 516 F.2d at 1237.

48 450 U.S. at 77. The Court stated "Congress did not intend the BHC Act to limit the Board's discretion to *approve* securities-related activities as closely related to banking beyond the prohibitions already contained in the Glass-Steagall Act." (emphasis added). The Board notes

However, the Court's opinion did not address the relevant issue here—the scope of the Board's discretion under section 4(c)(8) to *deny* or place prudential limitations on securities activities that, while consistent with the Glass-Steagall Act, may not comply with the separate requirements of the BHC Act. Moreover, Applicants have produced no evidence in the legislative history that the Board was not to exercise its discretion under the closely related to banking and public benefits tests of section 4(c)(8) regarding specific proposals merely because they involve securities activities that are not unlawful under the Glass-Steagall Act.

A. Closely Related to Banking Analysis.

After carefully considering the facts of record, the Board concludes that underwriting and dealing in commercial paper, municipal revenue bonds and 1-4 family mortgage-related securities, under the limitations discussed in this Order, are closely related to banking, because banks provide services that are so operationally and functionally similar to the proposed services that banking organizations are particularly well equipped to provide such services. As the Board has previously noted, the proposed activities are a natural extension of activities currently conducted by banks, involving little additional risk or new conflicts of interest under the framework established in this Order, and potentially yielding significant public benefits in the form of increased competition and convenience and lower cost.[49] On

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that the legislative history to which the Court refers to support this conclusion indicates that the BHC Act was *not* intended to liberalize the Glass-Steagall Act. That legislative history does not indicate, as Applicants claim, that activities that do not violate the Glass-Steagall Act are exempt from scrutiny under the standards of the BHC Act. Under the plain terms of the BHC Act, such activities clearly are not permissible for bank holding companies unless they pass muster under the standards of section 4(c)(8).

49 *See, e.g., Financial Restructuring: The Road Ahead: Hearings on H.R. 5342, 4506 and 3537 Before the Subcomm. on Telecommunica-*

this basis, the Board has urged the Congress to authorize these activities for bank holding companies as part of a Congressional reevaluation of the powers of banking organizations generally. This view is not held by the Board alone. The other federal banking agencies as well as the U.S. Departments of Treasury and Justice have also supported these activities.[50]

Accordingly, and for the reasons set forth in the *Chase* decision, the Board believes that underwriting and dealing in commercial paper is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. For the reasons set out below, the Board also concludes that underwriting and dealing in the proposed municipal revenue bonds and 1-4 family mortgage-related securities is closely related to banking.[51]

Member banks are actively engaged pursuant to specific legislative authorization in a variety of underwriting and dealing activities that are closely analogous to the proposed municipal revenue bond and mortgage-related securities underwriting activities. Section 16 of the Glass-Steagall Act authorizes member

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tions, Consumer Protection, and Finance of the House Comm. on Energy and Commerce, 98th Cong., 2d Sess. 91 (1984) (Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System), reprinted in 70 FEDERAL RESERVE BULLETIN 312, 316 (1984); Statement of Chairman Volcker Before the Subcomm. on Commerce, Consumer & Monetary Affairs of the House Comm. on Government Operations (June 11, 1986), reprinted in 72 FEDERAL RESERVE BULLETIN 541, 549 (1986). *See also* S. Rep. No. 560, 98th Cong. 2d Sess. 15-16 (1984).

50 *Competitive Equity in the Financial Services Industry: Hearings on S.2181 Before the Senate Comm. on Banking, Housing, and Urban Affairs* ("Hearings on S.2181"), 98th Cong., 2d Sess. 1221, 1274, 1550, 1714 (1984) (Statements of C. Todd Conover, Comptroller of the Currency, William M. Isaac, Chairman, F.D.I.C., Douglas H. Ginsburg, Deputy Assistant Attorney General, U.S. Department of Justice, and Donald T. Regan, Secretary of the Treasury, respectively).

51 While Applicants have applied to underwrite and deal in mortgage-related securities generally, the Board believes that, at least on the current record, only underwriting and dealing in mortgage-related securities backed by 1-4 family residential mortgages will avoid significant risks and other adverse effects, as explained below.

banks to underwrite and deal in certain municipal revenue bonds (generally, those issued for housing, university or dormitory purposes), as well as municipal general obligation bonds ("GOs").[52] 12 U.S.C. 24 Seventh. Bank-eligible municipal revenue bonds accounted for between 31 and 52 percent of all municipal revenue bonds issued during the years 1980 to 1984, with banks accounting for between 19 to 26 percent of the underwriting market.[53] Banks have also historically underwritten a major share of new general obligation bond issues.[54]

Section 16 also authorizes member banks to underwrite and deal in mortgage-related securities that are issued or guaranteed by federal agencies. As Congress has recognized, banks are extensively involved in this activity.[55]

In addition to the fact that banks already underwrite and deal in certain types of municipal revenue bonds and mortgage-related securities, banks have developed extensive expertise in underwriting and dealing in U.S. government and agency securities and are among the nation's leading underwriters of these securities. For example, banks or bank affiliates constitute 17 of the 40 primary dealers in the government securities market and are among its largest participants.[56] In addition, banks are among the nation's largest underwriters of general obligation bonds.

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52 GOs represent a general debt obligation of a municipality, while a revenue bond represents a charge against the revenues of a facility or project financed by the bonds.

53 *Bank Eligible Revenue Bonds Compared to Total Revenue Bonds* (Exhibit E) and *Bank-Eligible Revenue Bonds Managed by Banks* (Exhibit F), Citicorp Application.

54 Dealer Bank Ass'n Comment, Exhibit III, Tables IIb and IIIb (July 22, 1985); Citicorp Application , p. 20, citing data obtained from Securities Data Corporation.

55 *See* S. Rep. No. 293, 98th Cong., 1st Sess. (1983).

56 For example, in 1984, banks accounted for nearly 30 percent of all U.S. government obligations underwritten. Department of Treasury, *Treasury Bulletin*, Fall 1984, Table PDO4.

In the Board's view, definite functional and operational similarities exist between the securities that member banks may underwrite and deal in and the municipal revenue and mortgage-related securities proposed by Applicants for their underwriting subsidiaries. The techniques involved in underwriting and dealing in these bank-eligible securities are the same, or substantially the same, as those that would be involved in conducting the proposed municipal revenue and mortgage-related securities activities. In each case the underwriter must perform substantially identical functions of credit evaluation and analysis, negotiation or bidding, distribution, and dealing. For example, investment banking firms that underwrite and deal in municipal revenue bonds generally utilize the same personnel and marketing techniques for their activity in general obligation bonds.[57]

The Board also notes that the evaluation and credit analysis that would be performed in connection with underwriting municipal revenue bonds and mortgage-related securities is functionally and operationally similar to the evaluation and credit analysis banks conduct when making loans to customers and in connection with their investment advisory and trust activities. In addition, Applicants' role in advising issuers in structuring an offering and contacting potential purchasers is functionally and operationally similar to a bank's role in advising customers and arranging loan participations and syndications.

The Board also believes that underwriting and dealing in these securities is functionally and operationally similar to the role of a bank in underwriting and dealing in money market instruments, establishing mortgage pools and evaluating the underlying risks of the constituent elements in a pool, advising municipalities and other issuers and assisting them in the pri-

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57 R. Plotkin, *What Meaning Does Glass-Steagall Have For Today's Financial World?*, 95 Banking L.J. 404, 412 (1978).

Municipal securities dealers and brokers, including bank dealers, are subject to the same regulatory system developed by the Municipal Securities Rulemaking Board under Section 15B of the Securities Exchange Act. 15 U.S.C. § 78o-4.

vate placement of their notes, and generally assessing credit and interest rate risk.[58]

Protestants contend that there is a major difference between underwriting activities permitted member banks under the Glass-Steagall Act and those proposed by Applicants, because bank-eligible securities are generally offered to dealers through competitive bidding while the price of most revenue bonds and other securities involved in Applicants' proposals is usually negotiated. Given the wide commercial bank participation in the underwriting of and dealing in U.S. government, municipal and other bank-eligible securities as a whole, the Board believes that banks are sufficiently familiar with negotiating processes as well as those involved in competitive bidding. The Board also notes that banks are involved in the negotiating process through their private placement activities for ineligible securities, including ineligible municipal revenue bonds, and their securities activities overseas.[59] Moreover, in the case of municipal securities specifically, this distinction is not significant because many revenue issues are offered by public bid, and the number of general obligation bonds sold by negotiation has been increasing.[60]

With respect to mortgage-related securities, the Board notes that the operations and functions (including credit and cash flow analysis, bidding process, distribution and dealer activities) involved in underwriting and dealing in bank-eligible mortgage-related securities and 1-4 family mortgage-backed securities are virtually identical, regardless of whether a federal or private entity issues or guarantees the securities involved.[61] Because the mortgage-backed securities proposed for the subsidi-

58 *See* Hearings on S.2181 at 1612 (Statement of Paul A. Volcker).

59 *See* Comptroller of the Currency, Federal Deposit Insurance Company, and Federal Reserve Board, Commercial Bank Private Placement Activities (1978); 12 C.F.R. 211.5(d)(13) (underwriting, distributing, and dealing in debt and equity securities outside the United States).

60 F. Fabozzi, S. Feldstein, I. Pollack, F. Zarb, *The Municipal Bond Handbook*, Volume One 172-73 (1983).

61 *See generally* C. Edson and B. Jacobs, *Secondary Mortgage Market Guide* (1985).

aries are not directly issued or guaranteed by the federal government or government-sponsored agencies, the subsidiaries will be required to conduct a more extensive credit analysis and evaluation of issuers and underlying mortgages than in underwriting bank-eligible mortgage-related securities. Given the experience of Applicants and banking organizations generally in evaluating credit in lending and investment functions[62] as well as in permissible underwriting activities where credit analyses are commonly made, for example, in connection with underwriting general obligations of States and municipalities, the Board does not believe this difference between bank-eligible mortgage-related securities and Applicants' proposed activity is significant. In this regard, the Board notes that banks underwrite substantial amounts of housing-related municipal bonds,[63] an activity that involves substantially the same credit analysis function as will be required for Applicants' mortgage-related securities.

Based on the foregoing analysis, the Board concludes that banking organizations, including Applicants, perform services that are functionally and operationally similar to the proposed activities of underwriting and dealing in certain municipal revenue bonds and 1-4 family mortgage-related securities and that they would be particularly well equipped to provide these underwriting and dealing services.

Citicorp and Bankers Trust also propose to underwrite and deal in CRRs. Although they note certain similarities between CRRs and mortgage-related securities and between banking activities involving the underlying loan obligations represented by those securities, the Board does not believe that the record before the Board at the present time provides a sufficient basis for it to make the formal finding required by the BHC Act that underwriting and dealing in CRRs is closely related to banking and a proper incident thereto. The market for CRRs is rela-

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62 *See, e.g.*, 12 C.F.R. 1.5, 1.8; M. Stigum, *The Money Market* 657 (2d ed. 1983).

63 *See* S. Rep. No. 293, 98th Cong. 1st Sess. 9 (1983) ("National banks . . . are currently intimately involved in mortgage finance including mortgage revenue bonds and the federal mortgage market agencies.").

tively new and untested compared to the market for the 1-4 family mortgage-related securities and municipal revenue bonds involved in these proposals. As Citicorp notes, the securitization of consumer loans and receivables is now in its early stages, and for that reason, "it is impossible to predict with certainty the direction in which this activity will evolve."[64] The Board, however, will reconsider this matter within the next sixty days on the basis of fuller submissions by Applicants regarding the types of assets that will be securitized, the manner in which this will be accomplished, and other matters bearing on risk. This will enable the Board to examine appropriately the risks involved and whether any safeguards are necessary to meet the requirements of the BHC Act.

B. Proper Incident to Banking Analysis.

In order to approve an application to engage in a nonbanking activity under section 4(c)(8) of the Act, the Board must determine that a proposed activity is a "proper incident" to banking by determining whether the performance of the activity by the applicant bank holding company may reasonably be expected to produce public benefits, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices. 12 U.S.C. § 1843(c)(8). Based upon the facts of record and for the reasons and subject to the limitations set out below, the Board finds that the proposed underwriting and dealing activities (other than for CRRs) may reasonably be expected to result in substantial public benefits that outweigh possible adverse effects.

1. Public Benefits.

The Board believes that the expansion of Applicants' activities to include underwriting and dealing in municipal revenue bonds, 1-4 family mortgage-related securities, and commercial paper should result in substantial public benefits in the form of

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64 Letter, dated April 19, 1985, to Federal Reserve Bank of New York, 8-9.

increased competition, greater convenience and gains in efficiency.

Increased Competition. The Board has previously recognized that the *de novo* expansion by a bank holding company into nonbanking activities generally may be expected to be procompetitive and result in increased competition.[65] These proposals represent a *de novo* expansion by Applicants into new segments of the markets for commercial paper, municipal revenue and 1-4 family mortgage-related securities, and thus may be expected to increase competition. The Board concluded in the *Chase* case that the expansion of a bank holding company's activities in the commercial paper market, which is highly concentrated, would foster competition.

Concentration ratios for those segments of the mortgage-related and municipal securities markets in which banking organizations have not participated are significantly higher than those for the bank-eligible segments of these markets. The introduction of new competitors into these markets may be expected to reduce concentration levels and, correspondingly, to reduce financing costs, underwriting spreads, and increase the availability of services to issuers.[66] Increased competition may be expected to benefit smaller and infrequent issuers, such as

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65 *See, e.g.*, section 225.24 of Regulation Y (12 C.F.R. 225.24); 49 *Federal Register* 814 (1984). Congress has also recognized that public benefits of increased competition and innovation may be anticipated through *de novo* expansion by bank holding companies into nonbanking activities. H.R. Rep. No. 1747, 91st Cong. 2d Sess. 16-17 (1970); S. Rep. No. 1084, 91st Cong. 2d Sess. 15-16 (1970); *Alabama Ass'n of Insurance Agents* v. *Board of Governors of the Federal Reserve System*, 533 F.2d 224, 249 (5th Cir. 1976), *cert. denied*, 435 U.S. 904 (1978).

66 *See* U.S. Department of the Treasury, Public Policy Aspects of Bank Securities Activities 34 (1975); Bank Holding Company Legislation and Related Issues: *Hearings on H.R. 2255, 2747, 2856 and 4004 Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 96th Cong. 1st Sess. 1299-1302 (1979) (statement by J. Charles Partee, Member, Board of Governors of the Federal Reserve System); S. Rep. No. 560, 98th Cong., 2d Sess. 15-16 (1984).

rural communities, which currently have relatively few choices among underwriters.

Benefits in the form of reduced financing costs and increased availability may be expected to accrue as well to the original borrowers under mortgage-related and municipal securities—homeowners and public entities—whose ability to borrow is directly related to the secondary market for their liabilities. Increased competition may also foster innovation among participants in these markets.

In this regard, the report of the Senate Committee on Banking, Housing and Urban Affairs on the proposed Financial Services Competitive Equity Act (S. 2851, 98th Cong., 2d Sess. (1984)) concluded that authorization for bank holding companies to underwrite municipal revenue bonds "will result in significant benefits to governmental issuers of these obligations and thus to their residents and taxpayers who must ultimately bear the cost of public borrowing."[67] The Board also notes that associations of state and municipal governmental organizations, including the National Governors Association and the National League of Cities, support bank holding company entry into municipal revenue bond underwriting in order "to increase competition for underwriting municipal revenue bonds and in view of the potential for this initiative to reduce significantly the cost of revenue financing."[68] National trade associations of home builders and realtors support bank holding company entry into the mortgage-backed securities underwriting business in order to increase competition.[69]

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67 S. Rep. No. 560, 98th Cong., 2d Sess. 16 (1984).

68 Letter from the National Governors Association to Jake Garn, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate (June 12, 1984), quoted in S. Rep. No. 560, 98th Cong., 2d Sess. 16 (1984); letter to the Board from the National League of Cities (July 19, 1985) (commenting on Citicorp application).

69 Letters to the Board from the National Association of Home Builders (July 22, 1985) and from the National Association of Realtors (July 18, 1985) (commenting on Citicorp application).

Greater Convenience and Increased Efficiency. The Board also finds that approval would result in public benefits in the form of greater convenience to customers and increased efficiency in the provision of the proposed services. As the Board has previously concluded, underwriting and dealing in commercial paper by a bank holding company would produce these public benefits.

Bank holding companies would be able to offer their borrowing customers an additional service and means of financing that may be more economical for the borrower. In addition, Applicants would be able to offer commercial paper to the same institutional investor customers that currently purchase other money market instruments, such as short-term U.S. government securities, certificates of deposit and bankers' acceptances, thereby increasing services to buyers of money market instruments and leading to greater efficiency in the market for short-term debt.

Issuer-customers of Applicants' existing underwriting services in municipal and mortgage-related securities would no longer be restricted to the bank-eligible segments of the markets for those securities when doing business with these bank holding companies. The increase in the number of dealers in these securities would also be likely to enhance liquidity in the markets for these securities, thereby increasing market efficiency.

More efficient operation of the markets for the proposed securities would benefit investors and issuers who are customers of Applicants and other market participants by narrowing the underwriter's and dealer's spread on sales transactions and making it easier to match buyers and sellers of the proposed securities.

2. Adverse Effects.

In the Board's December 1986 decision permitting Bankers Trust to place commercial paper as agent, the Board adopted a framework which had been put in place by Bankers Trust in order to address the possibility of adverse effects, such as unsound banking practices or conflicts of interest, that the Board must consider under the "public benefits" test in section

4(c)(8).[70] When the Board ordered a hearing on these applications, the Board requested specific comment on whether the Bankers Trust framework or other limitations that the Board was considering and that were listed in the Hearing Order should be adopted with respect to these proposals.

Comments of Interested Persons. The protestants believe that significant adverse effects are presented by the proposal, including potential conflicts of interest caused by the underwriting subsidiaries' "salesman's stake" and promotional incentives in the securities it underwrites or deals in, loss of public confidence in the bank if the affiliate experiences losses on its securities activities, risk to the bank holding company as a result of possible underwriting losses by the affiliate, undue concentration of resources resulting from greater domination of financial markets by banking organizations, and unfair competition, such as the affiliate obtaining funding from low cost bank deposits or access to confidential customer information held by the bank.

The protestants and several other commenters also expressed doubts as to the effectiveness of the suggested conditions and limitations to address these concerns. The SIA believes conditions such as those listed in the Board's Hearing Order would be inadequate to address all possible concerns. Salomon Brothers expressed the view that where the same or affiliated entities are both lenders and underwriters, no safeguards would be fully adequate to prevent abuses. Other protestants believe that restrictions must also be directed at establishing a "level playing field" for banking organizations and investment banking firms engaged in the proposed activities.

Applicants and certain other commenters contend no significant adverse effects would arise under these limited proposals involving securities with which bank holding companies have experience, particularly in light ot the voluntary controls Applicants would impose on themselves to limit risk and prevent conflicts and the applicable requirements of securities laws and

70 The Board adopted a similar set of limitations to address possible adverse effects in approving the application by Chase to underwrite and deal in commercial paper.

regulations. A few commenters believe the Board should establish further conditions to address risk or conflicts and to insulate the underwriting subsidiaries from their affiliated banks, such as a capital adequacy requirement for the underwriting subsidiary and limitations on transactions between the subsidiary and bank affiliates.

Applicants and certain other banking organizations objected to a number of the conditions listed in the Board's Hearing Order. In general, Applicants believe that any conflicts presented by the proposals are similar to the conflicts already successfully handled by bank holding companies and investment banking firms and that existing regulation by the SEC of broker-dealers, rules of the National Association of Securities Dealers ("NASD") and the Municipal Securities Rulemaking Board ("MSRB") applicable to broker-dealers trading in the proposed securities, and fiduciary requirements under common law and banking regulation are adequate to address the Board's concerns. They commented that a number of the conditions being considered by the Board to address possible conflicts of interest could interfere with their ability to compete or would be unnecessary or confusing in light of existing regulation.

Based on the record of the applications, and after careful consideration of the comments of interested parties, the Board finds that the potential for conflicts of interest, unsound banking practices, as well as other adverse effects are not likely to result from these proposals under the conditions and limitations established by the Board in this Order for the conduct of the proposed activities as well as the various statutory protections Congress has provided over the years to regulate the conduct of these activities. As discussed below, the Board has carefully considered the comments relating to the need for specific limitations and has concluded that, although existing regulation addresses certain of the concerns of the Board, there are areas in which the existing regulatory framework has not been demonstrated on the present record to be effective where commercial banking and investment banking organizations are affiliated. The Board notes that the BHC Act addresses broader concerns relating to safety and soundness and maintenance of public

confidence in banking organizations and impartiality in the credit-granting process, concerns that are not addressed by the statutory and regulatory provisions relating to investor protection to which Applicants refer. Accordingly, the Board has determined that this existing regulatory framework needs to be supplemented through additional limitations drawn from the list on which the Board sought comments at the hearing in order to address issues peculiar to the affiliation of ineligible securities underwriters and banking organizations.

General Considerations. At the outset, the Board notes that there are several general considerations that support a finding that these proposals as limited by Applicants and in this Order would not produce significant adverse effects. First, a great many of the adverse effects the Board is charged with considering under the public benefits test of section 4(c)(8), such as unsound banking practices and conflicts of interest, relate to potential damage to the holding company's subsidiary bank that might result from the conduct of proposed nonbanking activity. Accordingly, while a bank cannot be completely insulated from the fortunes of an affiliated nonbanking subsidiary, the Board believes that the greater the extent to which the nonbanking activity of a nonbank subsidiary of a holding company is insulated, both structurally and operationally, from the holding company's subsidiary banks, the less likely it is that adverse effects related to the conduct of the nonbanking activity will affect affiliated banks.[71]

In determining that adverse effects are not likely in these cases, the Board places substantial reliance on the fact that the proposed underwriting and dealing activities would be separated from the activities of Applicants' subsidiary banks, both through separate incorporation and through financial and operational limitations, explained below, that are specifically designed to ensure that all aspects of the proposed securities activities are insulated in operation from subsidiary depository institutions. For example, the proposed activities will not be

71 *Bankers Trust*, 73 FEDERAL RESERVE BULLETIN at 149, quoting *National Westminster Bank, PLC*, 72 FEDERAL RESERVE BULLETIN 584, 588 (1986), *petition for review pending*, No. 86-1412 (D.C. Cir.).

conducted by Applicants' subsidiary banks or by the banks' personnel. Each Applicant has agreed that its underwritng subsidiary will have no common officers, directors, or employees with Applicant's subsidiary banks. The Board believes that the prohibition on personnel interlocks should extend to any thrift subsidiary, as well, in order to assure that all federally-insured depositors are protected as much as possible. In addition, the Board requires that affiliated banks may not act as agents for or engage in marketing activities on behalf of the underwriting subsidiaries. The underwriting subsidiaries should also have offices separate from any affiliated bank.[72]

Moreover, transactions between the affiliated banks and the underwriting subsidiaries will be strictly limited, as discussed below. The underwriting subsidiaries will also be subject to a number of disclosure requirements designed to ensure that the public will not confuse the underwriting subsidiaries with their affiliated banks, including a requirement that the underwriting subsidiaries provide their customers with a special disclosure statement describing the difference between them and their affiliated banks. Limitations are also imposed preventing self-dealing in transactions between these subsidiaries and their affiliated banks acting in a fiduciary capacity. The Board also requires that the underwriting subsidiaries' access to customer records of the affiliated banks be limited and that the subsidiaries' affiliates be restricted in extending credit to customers for the purchase of securities from the subsidiaries during the course of the underwriting.

Under limitations imposed by the Board, the underwriting subsidiaries would be capitalized on a stand-alone basis, that is, each subsidiary must be capitalized independently of the parent

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72 The Board notes that the FDIC has recently proposed to amend its regulations governing the securities activities of affiliates of nonmember banks to provide that if the bank conducts business in the same location as the affiliate the bank must use physically separate offices or office space from that used by the affiliate. Such offices would have to be clearly and prominently identified so as to distinguish the bank from the affiliate. 52 *Federal Register* 11,492, 11,498 (April 9, 1987).

company and its subsidiary banks in accordance with industry norms.

Second, the limited expansion of activity proposed in the applications and the fact that the subsidiaries would remain fundamentally government securities dealers further support the findings that the specific adverse effects cited by the protestants are not likely to be a significant product of these proposals. The activity of each underwriting subsidiary with regard to ineligible securities would be limited in terms of income and market share so that they would not be substantial in the context of the subsidiary's overall operations and, moreover, each subsidiary would underwrite only a limited number of securities that are closely analogous, if not in most respects identical, to securities banks are authorized to underwrite and deal in or to commercial banking products. The fundamental nature of these subsidiaries would not be changed. They would remain government securities dealers and would in no sense be engaged in a full investment banking business.

Unsound Banking Practices. The Board has considered the extent to which these proposals would result in unsound banking practices or excessive financial risk to Applicants or their subsidiary banks through the underwriting subsidiaries' activities or through imprudent financial transactions with the underwriting subsidiaries or made for their benefit. In addition, the Board has considered whether the public association and economic union between the underwriting subsidiaries and their banking affiliates could lead to a loss of public confidence in Applicants' subsidiary banks if losses are sustained by the underwriting subsidiaries or by persons dealing with those subsidiaries.

Risk of Loss. Protestants allege that the proposals will result in unsound banking practices because the underwriting subsidiaries, acting as principals with respect to ineligible securities, could lose their own funds as a result of these operations. Such losses, protestants allege, could damage public confidence in affiliated banks and the parent company's ability to raise funds to provide to subsidiary banks.

The Board finds, however, that the risk of loss to Applicants or their underwriting subsidiaries as a result of these proposals is not excessive or inconsistent with prudent banking standards. As a preliminary matter, the Board notes that Applicants have applied to conduct a restricted form of underwriting and dealing that would be limited to securities that Congress has specifically authorized member banks to hold for their own account in the exercise of prudent banking judgment.[73] In fact, Congress recently authorized national banks to invest without limitation in private mortgage-related securities subject to regulations of the Comptroller of the Currency[74] on the basis that these securities do not jeopardize the safety and soundness of depository institutions because of the low-risk characteristics of the investment, *i.e.*, "a pool of many mortgages with relatively low default risk as well as mortgage insurance on both the individual mortgages and the pool."[75] Thus, to the extent the underwriting subsidiaries may hold ineligible securities for their own account as a result of these proposals, they will not be subject to any excessive or unmanageable risk of loss.

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73 A bank may exercise its prudent banking judgment to invest in any amount of the proposed mortgage-related securities if it is satisfied with the creditworthiness of the obligor. 12 U.S.C. § 24 Seventh; 12 C.F.R. 1.3 and 1.4. In the exercise of its prudent banking judgment, a bank may invest in the proposed municipal revenue bonds if it believes the obligor is creditworthy and the security is marketable. 12 U.S.C. § 24 Seventh; 12 C.F.R. 1.3 and 1.5. Banks have traditionally purchased commercial paper for their own account. *See Bankers Trust I*, 468 U.S. at 158 n.11.

74 Pub. L. No. 98-440, 98 Stat. 1691 (Oct. 3, 1984), amending 12 U.S.C. § 24.

75 S. Rep. No. 293, 98th Cong., 1st Sess. 6 (1983). Statistics also indicate that the performance of mortgage-related securities based on conventional (*i.e.*, non-federally insured) mortgages has been comparable to those issued or backed by the Federal agencies and/or Federal Housing Administration ("FHA") insurance. M. Waldman and S. Guterman, *Mortgage Securities: 1972-84, Historical Performance and Implications for Investors* (Salomon Brothers Inc, March 1985).

The Board, however, recognizes that in addition to credit risk, an underwriter and market maker also assume the risk of adverse changes in the market price of the securities involved. In addition, an underwriter or market maker may hold at any one time a substantially greater proportion of securities of a particular issuer than would be likely in the case of investors and must generally be prepared to provide liquidity for an issue. Nevertheless, the Board believes that the limited extension of activities proposed for the underwriting subsidiaries, which is substantially similar to operations safely and soundly being conducted presently by member banks, would not result in significant or excessive risk.[76] The risks associated with underwriting and dealing in any revenue bond, whether eligible or not, are generally a function of the price volatility of the security, as well as the cash flow and viability of the project being financed. These risks are not, in the Board's view, significantly greater for ineligible revenue bonds than for eligible bonds, given the very close functional similarity between the two kinds of obligations.[77] The same analysis applies to the proposed underwriting of ineligible mortgage-backed securities, whose risk characteristics are only slightly different from those of certain kinds of eligible mortgage-backed securities.

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76 *See* S. Rep. No. 560, 98th Cong., 2d Sess. 16 (1984).

The record does not show that there has been any particular safety and soundness or conflict of interest or abuses in the case of banks underwriting municipal general obligation bonds. *See Moratorium Legislation and Financial Institutions Deregulation: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 192 (1983) (statement of Paul A. Volcker).

77 In some cases, ineligible revenue bonds have higher ratings and lower yields than municipal securities eligible for underwriting by banks, including general obligation bonds. For example, according to Moody's 1985 Municipal and Government Manual, the general obligations bonds of New York City, which are eligible for bank underwriting, were rated "Baa," whereas the ineligible revenue bonds of related agencies, such as the New York City Transit Authority and the Triborough Bridge and Tunnel Authority were rated "Aaa" and "Aa," respectively.

Finally, as the Board recognized in *Chase*, underwriting and dealing in commercial paper is an activity that is similar to loan syndication and other similar operations presently conducted safely and soundly by member banks and involves a security that member banks may invest in as principal.[78]

The risk of underwriting and dealing in these securities is further mitigated by Applicants' experience in performing key functions that are similar to those performed by an underwriter or dealer in these types of debt securities, including credit analysis, evaluation of interest rate risk, financial planning, advice to issuers and assisting them in the private placement of their notes, and risk reduction techniques, such as hedging, diversification and other precautions applicable to the proposed activities.

Moreover, the Board notes that the underwriting subsidiaries will be subject to regulation under the federal securities laws. In particular, the subsidiaries will register with the SEC as broker-dealers and will be subject to financial reporting, anti-fraud and financial responsibility rules applicable to broker-dealers. These rules include the SEC's net capital rule (SEC Rule 15c3-1), which imposes capital requirements on broker-dealers that vary with the degree to which a broker-dealer acts as a principal and deals with the public. As noted below, Applicants' subsidiaries will maintain capital in excess of these requirements. In addition, the underwriting subsidiaries will be subject to the rules and regulations of the NASD and the MSRB. These requirements provide further protection against financial loss as a result of the proposed activities. The Board has previously recognized that in certain areas regulation under the federal securities laws is relevant to and may mitigate the Board's concerns

78 In addition, the Board has previously noted that the market risk associated with underwriting commercial paper is minimal. Before commercial paper is issued, dealers usually survey prospective purchasers to ascertain likely interest. Thus, the probability that the underwriter would incorrectly assess market conditions and would accordingly be required to hold large amounts of commercial paper for its own account is small. In any event, the short-term maturity of commercial paper, thirty days on average, limits the potential for large capital losses to the underwriting subsidiary.

over the possibility of adverse effects under section 4(c)(8) of the BHC Act.[79]

While the Board finds that the proposed activities do not generally present concerns about undue financial loss, the Board believes that underwriting and dealing in certain limited types of ineligible securities could give rise to unacceptable risk of loss, at least as indicated by the record currently before the Board. Therefore, the Board believes it prudent at this stage to place conditions on the types of ineligible securities that may be underwritten and dealt in pursuant to this Order. While municipal revenue bonds have not generally been characterized by substantial risk, certain new types of revenue bonds are being developed, particularly in the area of securities used to promote industrial development, that are riskier than traditional municipal securities or that may be operationally and functionally similar to corporate debt securities. Accordingly, the Board believes it appropriate to require that the underwriting subsidiaries may not, without further authorization from the Board, underwrite or deal in municipal securities other than those that are rated as investment quality (*i.e.*, in one of the top 4 categories) by a nationally recognized rating agency.[80] The Board notes that most of the types of revenue bonds Applicants propose to underwrite have not generally been associated with excessive risk and are frequently backed by insurance or letters of credit furnished by third parties, which further reduces the risk associated with these securities.

In light of recent adverse developments in the market for mortgage-related securities involving banking and thrift organizations, the Board also believes it appropriate to impose spe-

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79 *E.g.*, *BankAmerica Corporation*, 69 FEDERAL RESERVE BULLETIN 105, 113 (1983); *Fidelcor, Inc.*, 70 FEDERAL RESERVE BULLETIN 368, 369 (1984).

80 The Board notes that the underwriting subsidiaries proposed to underwrite "public ownership" industrial development bonds ("IDBs"), *i.e.*, tax exempt bonds where the issuing municipality or the state or local governmental unit on behalf of which the bonds are issued is treated for federal income tax purposes as the sole owner of the facility being financed. Without further approval from the Board, the underwriting subsidiaries may underwrite or deal in only these IDBs.

cific limitations on the types of such securities offered by the underwriting subsidiaries. Accordingly, the Board believes that Applicants' proposals to underwrite and deal in ineligible residential mortgage-related securities should be limited to obligations that are secured by or represent an interest in 1-4 family residential mortgages until additional experience is gained in other residential mortgage-related securities. In the Board's view, there are potentially greater risks associated with larger multi-family housing projects, which often have an element of commercial real estate development. The Board believes that mortgage-backed securities (other than those collateralized by 1-4 family residential mortgages) may in many instances involve significantly different and greater risk characteristics more akin to corporate underwriting, which the current record does not demonstrate may be handled safely with minimum risk within a bank holding company system. In addition, the mortgage-related securities collateralized by 1-4 family residential mortgages must be rated as investment quality (*i.e.*, in one of the top 4 categories) by a nationally recognized rating agency.

Finally, to insure that the subsidiaries' commercial paper activities remain limited to the kinds of obligations normally sold in the recognized commercial paper market, the underwriting subsidiaries may underwrite and deal in only prime quality, short-term obligations that are exempt from the registration requirements of the Securities Act of 1933 and that have minimum denominations of at least $100,000.[81]

The Board also finds that even if the underwriting subsidiaries were to encounter losses associated with the conduct of the proposed activities, these losses are not likely to represent any unwarranted risk of loss to the parent companies or Applicants' other subsidiaries under the various limitations and conditions discussed in this Order, which insulate the underwriting and dealing activities, both structurally and operationally from Applicants' subsidiary banks. These limitations serve to prevent

81 Commercial paper that qualifies for exemption under that Act typically is short-term (maturity of less than nine months), has large minimum denominations, and is issued by the largest and financially strongest corporations.

the underwriting subsidiaries' functions from draining the resources of the banks or from otherwise producing unsound banking practices.

Damage to Public Confidence. The Board also has determined that the proposed activities are not likely to damage public confidence in Applicants' subsidiary banks. First, the Board notes that damage to the reputation of affiliated banks is most likely to occur if the underwriting subsidiaries or customers who buy securities from them suffer losses. As explained above, the risk of loss on the kinds of securities that the underwriting industry will underwrite or deal in is carefully circumscribed. Also as explained above, under this proposal as approved by the Board, there are strict barriers between the underwriting subsidiaries and the affiliated banks, so that neither Applicants nor their subsidiary banks are responsible for any losses suffered by the underwriting subsidiaries.

Finally, in order to reduce further the association in the public mind between the bank holding company and its underwriting subsidiary and to prevent the direct or indirect involvement by the holding company in the ineligible activity approved only for underwriting subsidiary, the Board requires that each underwriting subsidiary provide to each of its customers a special disclosure statement describing the difference between the underwriting subsidiary and its banking affiliates and pointing out that the obligations of the underwriting subsidiary are not obligations of an affiliate bank and that the bank is not responsible for securities sold by the subsidiary. The statement should also disclose that an affiliated bank may be a lender to an issuer of ineligible securities underwritten or dealt in by the subsidiary and refer the customer to relevant disclosure documents for details. The Board notes that the Federal Deposit Insurance Corporation has recently proposed to require such disclosure in the case of affiliates of nonmember banks (52 *Federal Register 11,492, 11,497* (April 9, 1987)) and that Citicorp has indicated it proposes to provide a similar disclosure statement.

In the Board's view, the underwriting subsidiary should also disclose any material lending relationship between the issuer and a bank or lending affiliate of that subsidiary, as required

under the securities laws, and in every case whether the proceeds of that issue will be used to repay outstanding indebtedness to affiliates. In this regard, the Board notes that Citicorp, for example, recognizes that there should be extensive disclosure in the offering documents of any interest of an affiliated bank related to securities underwritten by CSI.[82]

The Board also requires that each underwriting subsidiary and any affiliated bank or thrift institution not engage in advertising or enter into an agreement stating or suggesting that an affiliated bank or thrift institution is responsible for the underwriting subsidiary's obligations. Applicants have each agreed to this limitation and certain other limits related to bank safety and soundness that are contained in the proposed section 23B of the Federal Reserve Act.[83]

To guard further against possible erosion of the public confidence in affiliated banks, no bank or thrift affiliate should act as agent for, or engage in marketing activities on behalf of, an underwriting subsidiary. The Board notes that Citicorp and Morgan have voluntarily agreed to such restrictions. In this regard, prospectuses and sales literature relating to securities underwritten or traded by the underwriting subsidiaries may not be distributed by bank or thrift affiliates; nor should any such literature be made available to the public at any offices of any such affiliate, unless specifically requested by a customer. (*See* 12 C.F.R. 225.125(h) regarding similar limitations on certain investment advisory activities of bank holding companies with respect to investment companies.) Additionally, affiliated banks or thrift institutions may not express an opinion with respect to the advisability of the purchase of ineligible securities underwritten or dealt in by the underwriting subsidiary, unless

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82 Morgan and Bankers Trust object to these conditions on the grounds that similar types of disclosures are required under the federal securities laws. In the Board's view, however, specific articulation of these disclosure requirements as a condition of the approval of these applications will help assure that public confidence in the subsidiary banks will not be impaired.

83 *See* S. 2851, 98th Cong., 2d Sess. (1984), 130 *Cong. Rec.* S 11162, S 11166-67 (September 13, 1984).

the bank or thrift affiliate notifies the customer that its affiliated underwriting subsidiary is underwriting or making a market in the security.

Conflicts of Interest. In determining whether the proposed underwriting and dealing activities, as limited above, are a proper incident to banking, the Board also has condsidered whether the activities would result in conflicts of interest. Given that the proposed activities would not be a substantial activity of the underwriting subsidiaries, the fact that banks have engaged in substantially similar activities without giving rise to significant conflicts, and the limitations on the activity as discussed below, the Board believes that any potential conflicts arising from the proposal are manageable and would not be significant.

At the outset, there are, in the Board's view, certain factors that limit the potential conflicts of interest that can reasonably be expected as a result of these proposals. First, as explained above, the limited underwriting and dealing operations in municipal revenue bonds, private mortgage-backed securities, and commercial paper would be performed by separate subsidiaries that are substantially insulated from the operations of the affiliated banks. Second, although to some extent the potential for conflicts of interest exists in connection with permissible securities and lending activities presently engaged in by member banks, there is no evidence that bank underwriting of eligible securities over the past 50 years has produced serious conflicts of interest or other abuses or encouraged imprudent lending practices.[84] Because the proposed activities involve securities that are substantially similar to those presently underwritten and dealt in by banks, the Board believes that the potential for

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84 *See* Federal Reserve Board Staff Study, Commercial Bank Private Placement Activities 64-65 (1977); U.S. Department of the Treasury, Public Policy Aspects of Bank Securities Activities 34 (1975); S. Rep. No. 560, 98th Cong., 2d Sess. 15-16 (1984); *Moratorium Legislation and Financial Institutions Deregulation: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 192 (1983) (statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System).

significant or new conflicts of interest with respect to the proposed ineligible securities would be manageable.

In this regard, the Board notes that in approving proposed legislation to allow bank holding companies to underwrite municipal revenue bonds, the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate relied on the similarity of the activity to bank eligible underwriting activity and the fact that banks have competed in the activity "safely and fairly for more than 50 years."[85]

The Board notes that, in the case of municipal revenue bonds, the fact that the issuer is a public entity makes potential conflicts less likely since these entities generally do not rely on bank lending for most of their funding. Similarly, issuers of securities backed by mortgages on 1-4 family residences do not rely significantly on bank funding.[86] Moreover, as the Board noted in approving commercial paper agency and principal activities in *Bankers Trust* and *Chase*, serving as a dealer in commercial paper is very similar in function to that of a lead bank in arranging loan participations or syndications, an operation that banks have traditionally performed. There is no evidence that banks' loan participation activities have produced serious conflicts of interest. Finally, while these general factors clearly reduce the potential for conflicts of interest, the Board believes that certain additional limitations, similar to those applied in the *Bankers Trust* and *Chase* decisions, are appropriate.

Credit to Purchasers of Securities. Protestants allege that Applicants' subsidiary banks may be encouraged to make imprudent loans to depositors for the purchase of securities underwritten by their affiliates. The Board notes that the possible temptation to extend credit for such purchases was a major concern leading to the enactment of the Glass-Steagall Act and that preserving the soundness and impartiality of credit granting is a major concern of the Board and other bank regulators under the banking laws. In order to address these concerns, the Board

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85 S. Rep. No. 560, 98th Cong., 2d Sess. 15 (1984).

86 *See Hearings on S. 2181*, at 1612 (statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System).

believes that it is appropriate to require that no lending affiliate of the underwriting subsidiary may extend credit to a customer that is secured by, or for the purpose of purchasing, any ineligible security that the subsidiary underwrites during the course of the underwriting or for the purpose of purchasing from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.[87] The Board notes Citicorp proposed a substantially similar limitation in connection with CSI's underwriting activities.

Credit to Issuers of Securities. The protestants also assert that a related conflict may also arise when Applicants' bank affiliates extend credit to issuers of securities underwritten or dealt in by the underwriting subsidiaries. It is argued that banks might be tempted to make unwise loans to improve the financial condition of companies whose securities are underwritten or dealt in by an affiliated underwriting subsidiary, either to assist in the marketing of the securities or to prevent the customers of the underwriting subsidiary from incurring losses on securities sold by the subsidiary. In order to assure that this conflict does not arise, the Board believes that neither Applicants nor any of their subsidiaries may make loans to issuers of ineligible securities underwritten by the underwriting subsidiaries for the purpose of the payment of principal and interest on such securities. To assure compliance with the foregoing limitation, any lines of credit extended by any lending subsidiary of Applicants to an issuer of ineligible securities underwritten by the underwriting subsidiaries must be for a documented special purpose, or have substantial participation by other lenders, and have substantially different timing, terms, conditions, and maturities from the ineligible securities being underwritten.

Applicants must adopt appropriate procedures, including maintenance of necessary documentary records, to assure that any extensions of credit by Applicants or any of their subsidi-

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87 This limitation extends to credit to all customers of the lending affiliates, including brokers, dealers, and unaffiliated banks, but does not include lending to a broker-dealer for the purchase of securities where an affiliated bank is the clearing bank for such broker-dealer.

aries to the issuer of ineligible securities underwritten or dealt in by the underwriting subsidiary are on an arm's length basis for purposes other than the payment of principal or interest on ineligible securities underwritten or dealt in by the securities subsidiaries. An extension of credit is considered to be on an arm's length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiaries.

In addition, the Board also believes that, to the extent the creditworthiness of securities sold by the underwriting subsidiaries depends on the existence of explicit financial backing of the issuer, that backing should be supplied by lenders unaffiliated with Applicants. Thus, the Board believes it appropriate to require that neither Applicants nor any of their subsidiaries issue or enter into a standby letter of credit, asset purchase agreement, indemnity, insurance, or other facility that might be viewed as enhancing the creditworthiness or marketability of ineligible securities underwritten, placed or dealt in by the underwriting subsidiaries. This limitation will further assure that the proposed activities do not encourage less than sound credit practices. For example, without such a prohibition, an affiliated bank might be tempted to provide a letter of credit to support a commercial paper issue that would otherwise not be of prime quality in an effort to make the issue marketable.

The Board believes that the above requirements relating to credit extensions to issuers should also apply to extensions of credit to parties that will be major users of the projects that are financed by industrial revenue bonds underwritten by the underwriting subsidiary. This restriction will avoid the potential conflict that a bank may be tempted to make imprudent loans to those who will benefit from a particular industrial revenue bond project in order to ensure the success of the project being financed.

Applicants generally oppose any broad restriction on the provision of credit support by affiliated banks to issuers whose securities are sold by the underwriting subsidiaries. Applicants contend that banks currently provide letters of credit and simi-

lar facilities to issuers of municipal securities underwritten by the bank. Applicants also argue that economic reality would deter preferential lending in support of an underwriting subsidiary's activity because the potential exposure to the bank on an unsound loan would be greater than the underwriting and trading profits to be gained by the subsidiary.

However, the Board believes that the risk that a bank's credit judgment may be impaired by the existence of an investment banking relationship between a borrower and the bank's affiliate is one of the fundamental hazards at which the Glass-Steagall Act was aimed and is a significant consideration under the standards of section 4(c)(8) of the BHC Act, which are designed to maintain impartiality in the credit-granting process and thereby promote public confidence in banking organizations. A similar restriction was relied on by the Board in the *Bankers Trust* and *Chase* decisions.

Credit and Advances to Underwriting Subsidiaries. The protestants also assert that Applicants' subsidiary banks may be tempted to make imprudent extensions of credit or other investments to support the underwriting subsidiaries if they encounter financial difficulties. This conflict is inherent in transactions between banks and their affiliates generally and is addressed by section 23A of the Federal Reserve Act. (12 U.S.C. § 371c(c)(1)). That provision limits extensions of credit by a bank to its nonbank affiliates, as well as asset purchases from an affiliate, to 10 percent of the bank's capital and requires that any extensions of credit be collateralized (*e.g.*, 110 percent of the extension of credit if the collateral is composed of revenue bonds). Section 23A also prohibits a bank from purchasing low quality assets or accepting them as collateral. Section 23A thus imposes limits on the techniques that might be used to transfer funds of an affiliated bank to an underwriting subsidiary. Applicants have also agreed to comply with certain of the limits contained in the proposed section 23B of the Federal Reserve Act.[88] These limitations require that all purchases and sales of assets between a bank affiliate of Applicants and the underwrit-

88 *See* S. 790, 100th Cong., 1st Sess. § 102(a) (1987), 133 Cong. Rec. S. 4061, S. 4063 (March 27, 1987).

ing subsidiaries, including transactions with third parties if the underwriting subsidiaries are a participant or have a financial interest in the third party or act as agent or broker or receive a fee for their services, be at arm's length and on terms no less stringent than those applicable to unrelated third parties.[89]

An additional potential conflict that might occur is the possibility that Applicants' subsidiary banks might make unwarranted purchases of securities underwritten or dealt in by the underwriting subsidiaries in order to assist the subsidiaries' marketing efforts or to prevent losses by the subsidiaries. The possibility that such securities might be dumped into the bank's inventory was a major concern underlying the Glass-Steagall Act. That such transactions represent a potential adverse effect is also evidenced by the fact that legislation recently considered by Congress contained a provision (the proposed new section 23B of the Federal Reserve Act) expressly dealing with this possibility in connection with eligible underwriting conducted directly by banks. Applicants maintain that the possibility of this adverse effect is mitigated on the basis that the securities being underwritten by the underwriting subsidiaries are eligible investments for banks and by existing regulatory requirements. Applicants point in particular to rules of the NASD, which prohibit a member engaged in a fixed price offering of securities (other than U.S. government or municipal securities) from selling such securities or placing them with an affiliate during the course of the underwriting.[90]

While the underwriting subsidiaries would be NASD members and subject to this rule against sales to affiliates, the rule does not apply to the offering of municipal securities, which is likely to be an important part of the subsidiaries' ineligible op-

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89 In particular, the transactions must be on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies or, in the absence of comparable transactions, those terms and circumstances that in good faith would be offered to, or would apply to, nonaffiliated companies.

90 Article II, § 1(m); Article III, § 36, NASD Rules of Fair Practice, NASD Manual (March 1985), ¶ 201-2196.

erations, and does not appear to address possible sales of unsold securities to an affiliate at the termination of the underwriting syndicate. In addition, although the limitations in section 23A would also be applicable in this situation, section 23A does not reach all inter-affiliate transactions.[91]

Accordingly, the Board believes that, in view of the significance of this concern, and a record indicating a basis for the Board's concern in these cases, Applicants and their subsidiaries (other than the underwriting subsidiaries) should not purchase, as principal, ineligible securities underwritten by the underwriting subsidiary during the underwriting period and for 60 days after termination of the underwriting and should not purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market. The Board believes this requirement is essential to address the potential for conflicts of interest that could have a detrimental impact on the financial resources of the affiliates of the underwriting subsidiaries.

Biased Investment Advice. Protestants also raise concerns relating to whether the proposals will impair Applicants' obligation to provide unbiased investment advice to trust department customers.[92] Applicants object to a proposed condition that would address this concern by precluding Applicants and their subsidiaries from purchasing as trustee or in any other fiduciary capacity ineligible securities underwritten or dealt in by their underwriting subsidiaries or from recommending to their customers the purchase of such securities.

Applicants note that banks and broker-dealers are already subject to extensive restrictions against self-dealing under the securities laws and banking regulation as well as under common law fiduciary requirements and that an absolute prohibition is

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91 Under section 23A, a bank affiliate could invest up to 10 percent of its capital in securities underwritten by an affiliate. In addition, section 23A does not apply in the case of assets having a readily identifiable and publicly available market quotation. Finally, section 23A does not apply to purchases by the parent holding company or other nonbank affiliates of securities underwritten by the underwriting subsidiary.

92 *See Bankers Trust I*, 468 U.S. at 146-147; *ICI I*, 401 U.S. at 633.

unnecessary given these restrictions and may not in fact be in the best interests of the bank's customers. In accordance with these standards, a bank or other investment adviser must disclose to an advisory customer any interest of its affiliate as underwriter or market maker in the securities being purchased or recommended and may not purchase such securities for a customer unless the purchases are specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered. For example, OCC Trust Banking Circular 19 generally prohibits national banks from purchasing in a fiduciary capacity securities underwritten by a commercial department of the bank either individually or as a syndicate member during the period of any underwriting or selling syndicate and creates a presumption that such purchases made for a period of 60 days after termination of the syndicate are also unlawful, except where authorized under the provisions of the governing trust instrument as noted above.

In addition, under fiduciary principles, affiliated banks may not express opinions about the advisability of investing in ineligible securities underwritten by the bank or its affiliates without disclosure. This limitation, which the Board believes should be explicitly applied to the underwriting subsidiaries, will assure that less than objective advice will not be provided by Applicants.[93] Moreover, each Applicant has committed that any dealings with the underwriting subsidiaries (or a company in which the subsidiary has an interest or for which it is acting as agent or underwriter) will be conducted on an arm's length basis and will

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93 Protestants have also raised the possibility that Applicants might not provide impartial advice to customers about the best method of obtaining funds or might not provide sound investment advice to correspondent banks. Under the terms of the Board's approval, the underwriting subsidiaries here would be insulated from the lending and other departments of affiliated banks and, to a large extent, the issuers of the ineligible securities that will be sold by the underwriting subsidiaries are financially sophisticated and are able to make their own assessment about various financing methods. Likewise, correspondent banks have significant expertise in investing in municipal and mortgage-related securities and have traditionally purchased commercial paper for their own account.

not involve preferential terms or conditions. As discussed above, each Applicant will also provide customers with a specific disclosure statement describing the difference between affiliated banks and the underwriting subsidiary. The Board believes these disclosure and fiduciary requirements, if followed by the bank holding company and its bank, thrift, investment adviser and trust company subsidiaries, are sufficient to address concerns regarding conflicts of interest involving bank affiliates acting in a fiduciary capacity.

Securities Issued by Affiliates. An additional concern has been raised regarding the potential conflicts that might arise if an underwriting subsidiary underwrites or deals in securities of affiliated entities, particularly those that may be experiencing financial difficulties.

In the Board's view, the incentives for a conflict of interest to arise in underwriting and dealing in an affiliate's securities could be substantial, depending on factors such as the extent, regularity, or purpose of such underwriting and dealing. The Board notes that Congressional concern over bank securities affiliates' underwriting and making markets in the securities issued by their bank affiliates was cited as one of the principal reasons for the Glass-Steagall Act. *ICI II*, 450 U.S. at 61-62. Specifically, where the underwriting subsidiary offers securities representing interests in pools of assets created by its affiliates, the temptation exists that the affiliates' least creditworthy assets would be securitized.

Applicants maintain that investment banking firms that are part of an integrated holding company organization are subject to the same conflict in selling their affiliates' securities and that this conflict has been addressed by the disclosure requirements under the securities laws and by NASD rules. The Board is unable to conclude on the basis of the record of these applications, however, that these requirements alone would be adequate. First, the fact that investment banking firms that are not affiliated with banks face this kind of conflict in underwriting affiliates' obligations is not probative here. These firms are not subject to the public benefits test in section 4(c)(8), which imposes an affirmative duty on the Board to consider potential

conflicts of interest associated with bank holding companies' nonbanking activities.

Second, the Board's concern in this case is not limited to the protection of investors. The reputation of affiliated banks could be damaged if the underwriting subsidiary sells securities issued by its affiliates to the public and those securities subsequently deteriorate in quality. Nor is it clear that disclosure requirements alone would be adequate, since the underwriting subsidiary may have an incentive to be less objective in evaluating creditworthiness and in describing all material facts when the subsidiary seeks to market obligations of entities under common control with it. The requirement of an unaffiliated underwriter will tend to ensure that an independent and impartial credit judgment will be made in connection with securities issued by a banking organization.

On the basis of the foregoing, the Board requires, as a condition to its Order in order to avoid this potential conflict, that an underwriting subsidiary may not underwrite or deal in any ineligible securities issued by its affiliates or representing interests in, or secured by, obligations originated or sponsored by its affiliates (except for grantor trusts or special purpose corporations created to facilitate underwriting of securities backed by residential mortgages originated by a nonaffiliated lender).

Securities to Repay Loans. The final category of potential conflicts of interest cited by protestants involves possible harm to the interests of those who purchase securities sold by the underwriting subsidiaries. Protestants contend that Applicants might encourage issuers to issue securities, the proceeds of which will be used to repay loans made by affiliated banks.

The Board believes that incentives to convert a risky loan held by an affiliate to a security sold to the public by the underwriting subsidiary are minimized by the condition in this Order that precludes underwriting or dealing in ineligible securities issued by affiliates, and by the economic disincentive for a bank holding company to jeopardize the reputation of its underwriting subsidiary as well as of its bank and other lending subsidiaries by engaging in underwriting for this purpose. The Board further believes that this abuse is made unlikely by the require-

ments, explained earlier in this Order, that the underwriting subsidiary should disclose to purchasers any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.

Finally, the Board also notes that the ineligible securities underwritten and dealt in by the underwriting subsidiaries will be rated by independent rating services. The necessity for objective credit ratings makes it extremely difficult for issuers experiencing financial difficulties to issue securities that will be accepted by the market. Accordingly, subject to the foregoing limitations, the Board believes that the proposal does not pose conflicts of interest sufficient to outweigh the public benefits of the proposal.

Unfair Competition. The Board has also considered protestants' contention that the proposed underwriting affiliates would have unfair competitive advantages over other underwriters and dealers that are not affiliated with banks. Protestants allege that Applicants would enjoy unfair advantages in, for example, the rates they would pay for funding; access to the credit files of banking affiliates to obtain information useful in marketing their services to issuers; and tax advantages available only to banks that hold municipal securities. The Board finds that this limited proposal would not result in unfair competition for the following reasons.

Access to Low-Cost Funds. With respect to protestants' funding claim, there is no evidence that Applicants' underwriting subsidiaries would, by reason of their affiliation with federally insured banks, enjoy access to lower cost funds than their competitors that are not affiliated with banks.[94] Funding for the underwriting subsidiaries would be provided by their parent holding companies, which are not banks. A corporation's funding costs are a function of a variety of economic factors, includ-

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94 The Board notes that banks do not dominate the markets for bank-eligible securities, suggesting that the alleged funding advantages for banks are not a significant competitive factor.

ing size, capital and earnings. While the regulatory framework under which a corporation operates is a factor that may affect cost of funds, the same bank regulatory structure that provides deposit insurance imposes restraints and important costs on the operation of banks and their affiliates that are not imposed on other corporations. In addition, rates paid by Applicants and other bank holding companies on their commercial paper have generally been the same as those paid by corporations of similar size and credit ratings.

As noted above, the underwriting subsidiaries would be corporations legally separate and apart from Applicants' banking affiliates. Accordingly, the underwriting subsidiaries would not obtain funding directly through federally insured deposits or the Federal Reserve's discount window, which is available to depository institutions. Moreover, the Board does not believe that there would be a strong likelihood that insured deposits or the proceeds of discount window loans could be transferred from affiliated banks to the underwriting subsidiaries, in view of the lending limitations and collateral requirements of section 23A of the Federal Reserve Act, and the fact that any other inter-affiliate transactions not subject to section 23A must be conducted on an arm's length basis.

In any event, as the Board noted in *BankAmerica/Schwab*, the legislative history of section 4(c)(8) of the Act indicates that the term "unfair competition" was intended to refer to unfair or unethical business conduct under the law, and not to disparities established by existing federal regulation of providers of financial services.[95] Accordingly, for the reasons set out in *BankAmerica/Schwab*, even if the underwriting subsidiaries might obtain some funding advantage by reason of their affiliation with Applicants, the Board finds that such advantage is not unfair competition within the meaning of section 4(c)(8) of the Act.

Access to Confidential Information. The Board has also considered the allegation that unfair competition would result from sharing of confidential information between the under-

95 69 FEDERAL RESERVE BULLETIN 105, 111 (1983), affirmed by the Supreme Court in *Schwab*.

writing subsidiaries and their affiliates, such as granting the underwriting subsidiaries access to the credit files of their affiliates to determine the financial needs of issuers and potential issuers to enable the subsidiaries to offer their services to issuers in advance of competitors.

To address the possibility of potential unfair competition or conflicts arising as a result of information sharing, Applicants state that they will voluntarily establish appropriate "Chinese walls" to prevent information acquired by the organization in one capacity from being improperly used in another area.

However, the Board does not believe that these commitments are sufficiently strong to assure that this conflict will not occur. Accordingly, as a condition of the Board's approval of these applications, no lending affiliate of the underwriting subsidiaries may disclose to the underwriting subsidiaries any nonpublic customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary, other than as required by securities laws.

With respect to the potential for adverse effects from the disclosure of confidential information held by an underwriting subsidiary to its affiliates, the Board notes that trading on inside information about issuers would violate the federal securities laws. Moreover, the incentive to gain access to confidential information possessed by the underwriting subsidiary is reduced by the prohibition discussed above on the purchase by any affiliate as principal or trustee from the underwriting subsidiary of securities distributed by the subsidiary. Nevertheless, the Board believes it appropriate to require that the officers or employees of an underwriting subsidiary may not disclose nonpublic customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary to its affiliates.[96]

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96 The Board notes that explicit tying of services offered by Applicants' subsidiary banks and by the underwriting subsidiaries is prohibited by section 106 of the Bank Holding Company Act Amendments of 1970. 12 U.S.C. §§ 1972-78.

Tax Treatment. Finally, the Board has considered protestants' argument that Applicants' subsidiary banks receive different tax treatment than general corporations with regard to interest expense for carrying municipal securities. However, the Board finds that banks' differing tax treatment does not constitute an unfair competitive practice. First, the Tax Reform Act of 1986 has significantly reduced the tax advantages available to banks with respect to interest expense for municipal securities.[97] The underwriting subsidiaries are not banks and would not have the benefit of tax provisions applicable to banks. In addition, under this Order the underwriting subsidiaries may not sell ineligible municipal securities to affiliates during the underwriting period and there is no evidence that Applicants intend to engage in transactions to place the underwriting subsidiaries' eligible municipal securities temporarily with affiliated banks to obtain any tax advantage.[98]

In any event, banks' tax treatment, like their coverage by deposit insurance, is a result of federal regulation, rather than of unethical or unfair business practice. As the Board specifically noted in *BankAmerica/Schwab*, any competitive advantage accruing from the favorable tax treatment accorded bank municipal securities dealers does not represent the type of adverse effect about which the Act was concerned.[99]

Undue Concentration of Resources or Decreased Competition. The Board has carefully considered the possibility that these proposals would result in an undue concentration of resources, in view of the size of Applicants and the concern expressed in the BHC Act regarding the concentration of control

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97 Pub. L. No. 99-514, § 902 (Oct. 22, 1986).

98 The possibility of such tandem operations occurring is also minimized by the fact that there will be no interlocking directors, management or employees among the underwriting subsidiaries and bank or thrift affiliates.

99 69 FEDERAL RESERVE BULLETIN at 111.

over credit resources.[100] The Board has also considered the contentions of protestant Salomon Brothers and others that the existence of severe limitations on banking institutions' securities activities prevents a concentration of resources and promotes competitive innovation between banking institutions and investment banking firms. The Board finds that these proposals are not likely to lead to undue concentration of resources or decreased competition under the facts and circumstances of and subject to the limitations imposed on the activities herein.

Applicants seek an expansion of authority to underwrite and deal in limited kinds of securities on a *de novo* basis and these proposals do not involve any combination of existing competitors. Thus, the proposals would not eliminate any existing provider of the services involved, but would add the underwriting subsidiaries as new competitors. Addition of new competitors may reasonably be expected to increase competition and promote deconcentration in the underwriting market for the types of ineligible securities proposed. The likelihood that these proposals would result in concentrations of resources is further reduced by the fact that in order to comply with the restrictions of section 20, the volume of ineligible revenue bonds and ineligible mortgage-backed securities underwritten by the underwriting subsidiaries in any one year will not exceed 5 percent of the total amount of each such kind of security underwritten domestically by all firms during the previous calendar year. Similarly, the volume of such ineligible securities held by the underwriting subsidiaries as a result of their secondary market activity may not exceed 5 percent of the total amount of that type of security underwritten domestically by all firms during the previous calendar year. Similar market limits apply to commercial paper activities.

Finally, the Board notes that, as authorized by section 16 of the Glass-Steagall Act, banks underwrite and deal in eligible securities without any market size limitation, and this authority

100 *See* H.R. Conf. Rep. No. 1747, 91st Cong., 2d Sess. 17 (1970) (Statement of the Managers on the Part of the House).

has not led to adverse effects with respect to concentration of resources. In fact, the markets for bank eligible securities are markedly less concentrated that those for ineligible securities.

Financial Factors. In evaluating these applications, the Board has carefully considered the financial resources of each Applicant, including its capital position, and the effect on these resources of the proposed activities. The Board has also considered the comments of the SIA and several other protestants that, after the initial capitalization of the underwriting subsidiaries, Applicants should be precluded from providing any additional capital support to the subsidiaries.

The Board has indicated on previous occasions that a bank holding company should be a source of financial strength to its subsidiaries, in particular to its banking subsidiaries, and that the Board will evaluate an application for expanding nonbanking activity with this consideration in mind. The Board has required holding companies seeking approval for new activities to have the financial resources to capitalize the nonbanking entity in accordance with industry standards generally and the risk factors involved in the activity in particular, with the aims of assuring, to the extent feasible, that the new activity can support itself on a stand-alone basis, while at the same time maintaining the bank holding company's ability to serve as a source of financial strength to its subsidiary banks.[101]

In these cases, the Board believes it is appropriate to exclude the capital (and related assets) of the underwriting subsidiaries from the consolidated capital that Applicants are required to maintain under the Board's Capital Adequacy Guidelines. In the Board's view, this exclusion of the capital of the underwriting subsidiaries is consistent with the preservation of the bank holding company's resources for subsidiary banks, and, in

101 *See* Statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, Before the Subcomm. on Commerce and Monetary Affairs of the Comm. on Government Operations. U.S. House of Representatives (June 11, 1986), *reprinted* in 72 FEDERAL RESERVE BULLETIN 541, 545 (1986); *State Bond and Mortgage Company*, 71 FEDERAL RESERVE BULLETIN 722 (1985).

the Board's view, a general prohibition against additional funding of the underwriting subsidiary by the parent holding company is unnecessary, provided that in each specific case the provision of funds to the subsidiary is not detrimental to subsidiary banks.

The Board further notes that the underwriting subsidiaries will be subject to a separate regulatory capital requirement—the SEC's net capital rule. Accordingly, the Board finds the proposed capitalization of each of the underwriting subsidiaries in these cases will be adequate under the generally accepted norms for companies engaged in similar activities. The Board will monitor the development and risk profiles of the underwriting subsidiaries in order to determine if their capital is adequate.

C. Pending Legislation.

In its consideration of this case, the Board has noted that on March 27, 1987, the United States Senate passed legislation that, if enacted, would prohibit Board approval between March 6, 1987 and March 1, 1988, of any application, such as the present proposals, that would permit a bank holding company to engage in the underwriting or public sale of securities on the basis that it was not "engaged principally" in such activity within the meaning of section 20 of the Glass-Steagall Act.[102] This prohibition would not apply to applications pending prior to the date of enactment of the legislation if the Board delays the effective date of the decision until the expiration of the moratorium.

This moratorium legislation, however, has not yet been enacted into law. Accordingly, and as the Board stated in the *Chase* decision, the Board is required as provided in existing law to act on these applications within mandated time periods and in accordance with the applications processing schedule prescribed by Regulation Y. Moreover, the applications, as noted, comply with existing law under the framework established by the Board in this Order.

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102 Competitive Equality Banking Act of 1987 (S. 790), 100th Cong., 1st Sess. § 201; 133 *Cong. Rec.* S. 4061, S. 4067 (March 27, 1987).

While the Board believes it must proceed to reach a decision on the applications, the Board calls to Applicants' attention that they may be required by subsequent Congressional action to cease their ineligible underwriting and dealing activities approved in this Order. The Board retains jurisdiction over the applications to act to carry out the requirements of any legislation adopted by Congress that would affect Applicants' conduct of underwriting and dealing activities under this Order and the Bank Holding Company Act.

Conclusion

In sum, the Board finds that these proposals, as limited by this Order, are consistent with section 20 of the Glass-Steagall Act and may reasonably be expected to result in public benefits that outweigh possible adverse effects. Accordingly, the Board finds that Applicants may conduct the proposed activities to the extent and in the manner described in this Order consistent with section 20 of the Glass-Steagall Act and section 4(c)(8) of the BHC Act. The Board's approval of these applications extends only to the activities conducted within the limitations of this Order as summarized below (and subject to the gross revenue and market share limitations discussed above), and underwriting or dealing in ineligible securities in any manner other than as described below and in this Order[103] is not within the scope of the Board's approval and is not authorized for the underwriting subsidiaries:

A. Types of Securities to be Underwritten

1. The underwriting subsidiaries shall limit their underwriting and dealing in ineligible securities to the following:

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103 The underwriting subsidiaries may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

a. *Municipal revenue bonds* that are rated as investment quality (*i.e.*, in one of the top four categories) by a nationally recognized rating agency, except that industrial development bonds in these categories shall be limited to "public ownership" industrial development bonds (*i.e.*, those tax exempt bonds where the issuer, or the governmental unit on behalf of which the bonds are issued, is the sole owner, for federal income tax purposes, of the financed facility (such as airports and mass commuting facilities)).

b. *Mortgage-related securities* (obligations secured by or representing an interest in 1-4 family residential real estate), rated as investment quality (*i.e.*, in one of the top 4 categories) by a nationally recognized rating agency.

c. *Commercial Paper* that is exempt from the registration and prospectus requirements of the S.E.C. pursuant to the Securities Act of 1933 and that is short term, of prime quality, and issued in denominations no smaller than $100,000.

B. Capital Investment

2. Each Applicant's investment in an underwriting subsidiary and the assets of the underwriting subsidiary shall be excluded in determining the holding company's consolidated primary capital under the Board's Capital Adequacy Guidelines.

C. Capital Adequacy

3. The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.

4. Applicants shall submit quarterly to the Federal Reserve Bank of New York FOCUS reports filed with the NASD or other self-regulatory organizations, and detailed information breaking down the underwriting subsidiaries' business with respect to eligible and ineligible securities, in order to permit

monitoring of the underwriting subsidiaries' compliance with the provisions of this Order.

D. Credit Extensions by Lending Affiliates to Customers of the Underwriting Subsidiary

5. No Applicant or subsidiary shall extend credit, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten by an affiliated underwriting subsidiary.

6. No lending affiliate of an underwriting subsidiary shall knowingly extend credit to a customer secured by, or for the purpose of purchasing, any ineligible security that an affiliated underwriting subsidiary underwrites during the period of the underwriting, or to purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market. This limitation extends to all customers of lending affiliates, including brokers-dealers, and unaffiliated banks, but does not include lending to a broker-dealer for the purchase of securities where an affiliated bank is the clearing bank for such broker-dealer.

7. No Applicant or any of its subsidiaries may make loans to issuers of ineligible securities underwritten by an affiliated underwriting subsidiary for the purpose of the payment of principal and interest on such securities. To assure compliance with the foregoing, any credit lines extended to an issuer by any lending subsidiary of the bank holding company shall provide for substantially different timing, terms, conditions and maturities from the ineligible securities being underwritten. It would be clear, for example, that a credit has substantially different terms and timing if it is for a documented special purpose (other than the payment of principal and interest) or there is substantial participation by other lenders.

8. Each Applicant shall adopt appropriate procedures, including maintenance of necessary documentary records, to assure that any extensions of credit to issuers of ineligible securities underwritten or dealt in by an underwriting subsidiary are on an arm's length basis for purposes other than payment of principal and interest on the issuer's ineligible securities being underwritten or dealt in by the subsidiary. An extension of credit is considered to be on an arm's length basis if the terms and conditions are substantially the same as those prevailing at the time for comparable transactions with issuers whose securities are not underwritten or dealt in by the underwriting subsidiaries.

9. The requirements relating to credit extensions to issuers noted in paragraphs 5-8 above shall also apply to extensions of credit to parties that are major users of projects that are financed by industrial revenue bonds.

E. Limitations to Maintain Separateness of an Underwriting Affiliate's Activity

10. There will be no officer, director, or employee interlocks between an underwriting subsidiary and any of the holding company's bank or thrift subsidiaries. The underwriting subsidiary will have separate offices from any affiliated bank.

F. Disclosure by the Underwriting Subsidiary

11. An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its banking affiliates and pointing out an affiliated bank could be a lender to an issuer and referring the customer to the disclosure documents for details. The statement shall also indicate that the obligations of the underwriting subsidiary are not those of any affiliated bank and that the bank is not responsible for securities sold by the underwriting subsidiary. The underwriting subsidiary should disclose any material lending relationship between the issuer and a bank or lending affiliate of the underwriting subsidiary as required under the securities laws and in

every case whether the proceeds of the issue will be used to repay outstanding indebtedness to affiliates.

12. No underwriting subsidiary nor any affiliated bank or thrift institution will engage in advertising or enter into an agreement stating or suggesting that an affiliated bank is responsible in any way for the underwriting subsidiary's obligations.

13. No bank or thrift affiliate of the underwriting subsidiary will act as agent for, or engage in marketing activities on behalf of, the underwriting subsidiaries. In this regard, prospectuses and sales literature of an underwriting subsidiary may not be distributed by a bank or thrift affiliate; nor should any such literature be made available to the public at any offices of any such affiliate, unless specifically requested by a customer.

G. Investment Advice by Bank/Thrift Affiliates

14. An affiliated bank or thrift institution may not express an opinion with respect to the advisability of the purchase of ineligible securities underwritten or dealt in by an underwriting subsidiary unless the bank or thrift affiliate notifies the customer that its affiliated underwriting subsidiary is underwriting or making a market in the security.

H. Conflicts of Interest

15. No Applicant nor any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period, or shall purchase from the underwriting subsidiary any ineligible security in which the underwriting subsidiary makes a market.

16. No Applicant nor any of its bank, thrift, or trust or investment advisory company subsidiaries shall purchase, as a

trustee or in any other fiduciary capacity, for accounts over which they have investment discretion ineligible securities

(i) underwritten by the underwriting subsidiary as lead underwriter or syndicate member during the period of any underwriting or selling syndicate, and for a period of 60 days after the termination thereof, and

(ii) from the underwriting subsidiary if it makes a market in that security, unless, in either case, such purchase is specifically authorized under the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.

17. An underwriting subsidiary may not underwrite or deal in any ineligible securities issued by its affiliates or representing interests in, or secured by, obligations originated or sponsored by its affiliate (except for grantor trusts or special purpose corporations created to facilitate underwriting of securities backed by residential mortgages originated by a non-affiliated lender).

18. All purchases and sales of assets between bank (or thrift) affiliates and an underwriting subsidiary (or third parties in which the underwriting subsidiary is a participant or has a financial interest or acts as agent or broker or receives a fee for its services) will be at arm's length and on terms no less stringent than those applicable to unrelated third parties, and will not involve low-quality securities, as defined in section 23A of the Federal Reserve Act.

I. Limitations to Address Possible Unfair Competition

19. No lending affiliate of an underwriting subsidiary may disclose to the underwriting subsidiary any nonpublic customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary (other than as required by securities laws and with the issuer's consent) and no officers or employees of the underwriting subsidiary may disclose such information to its affiliates.

J. Formation of Subsidiaries of an Underwriting Subsidiary to Engage in Underwriting and Dealing

20. Pursuant to Regulation Y, no corporate reorganization of an underwriting subsidiary, such as the establishment of subsidiaries of the underwriting subsidiary to conduct the activities, may be consummated without prior Board approval.

Because these proposals represent the first major entry of banking organizations into the field of underwriting and dealing in ineligible securities, the Board believes it appropriate to proceed cautiously and has established an extensive framework of prudential limitations to address conflicts of interest, unsound banking practices, and other adverse effects. After the underwriting subsidiaries have established a record of experience in the proposed activities, the Board may review the continued appropriateness of particular limitations. Similarly, the Board may from time to time, based upon experience with the activities, establish additional limitations on the conduct of the activities to ensure that the subsidiary's activities are consistent with safety and soundness, conflict of interest, and other considerations relevant under the BHC Act.

Based on the foregoing and other considerations reflected in the record, and as set forth in the Appendix, the Board finds that these proposals, as limited in this Order are consistent with section 4(c)(8) of the Bank Holding Company Act and section 20 of the Glass-Steagall Act, and may reasonably be expected to result in public benefits that outweigh possible adverse effects.[104] Accordingly, the Board finds that Citicorp, J.P. Mor-

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104 The SIA has requested the Board to release data submitted by Applicants in connection with these proposals concerning the volume of sales and income derived from underwriting and dealing in eligible securities since 1982, and their projected volume and income to be derived from underwriting and dealing in ineligible securities. The Board has accorded this information confidential treatment since public disclosure of this data could significantly impair Applicants' competitive

gan and Bankers Trust may conduct the proposed activities to the extent and in the manner described in this Order and Appendix consistent with section 4(c)(8) of the BHC Act.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of the holding companies or any of their subsidiaries as the Board finds necessary to ensure that the underwriting subsidiaries' activities are consistent with safety and soundness and conflict of interest considerations and to assure compliance with the provisions of the BHC Act and the Board's regulations and orders issued thereunder, or to prevent evasion thereof.

These transactions shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of New York, pursuant to delegated authority.

By order of the Board of Governors, effective April 30, 1987.

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position. The SIA states that disclosure of the data is necessary to ascertain the extent to which Applicants' capital will be at risk as a result of the proposals. The Board notes, however, that the underwriting and dealing activities of the underwriting subsidiaries in ineligible securities may not exceed 5 percent of the total market in such securities. Since these market limitations determine the maximum scope of the proposed activities and since market data are publicly available, release of the confidential data submitted by Applicants does not appear necessary. The additional information requested by the SIA is publicly available and involves the kinds of transactions with affiliates that are not permitted under this Order.

In addition, the Board does not believe this information is necessary for resolution of the other issues raised by the SIA. With respect to risk to Applicants' capital, the Board has required that Applicants may invest in the underwriting subsidiaries only to the extent that such funds would be in excess of the Board's capital requirements for bank holding companies and, as discussed above, the Board does not believe the potential for loss to Applicants or their other affiliates from the underwriting subsidiaries is substantial.

Voting for these actions: Governors Johnson, Seger, and Heller. Voting against these actions: Chairman Volcker and Governor Angell.

WILLIAM W. WILES
Secretary of the Board

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

We regret we are unable to join the majority in approving the pending applications.

The regret reflects the fact that, as a matter of policy, we support the idea that affiliates of bank holding companies underwrite and deal in commercial paper, municipal revenue bonds, and 1-4 family mortgage-related securities, the activities involved in the Board's decision.[1] Moreover, we agree generally with the nature of the limitations placed upon the activities in the Board decision, assuming the threshold question of their legality in the *particular form proposed* can be answered affirmatively.

Our point of difference involves precisely that question of law. Section 20 of the Glass-Steagall Act provides that no member bank may be affiliated with any corporation engaged principally in the underwriting of stocks, bonds, debentures, notes or other securities. We believe the plain words of the statute, read together with earlier Supreme Court and circuit court opinions, as we understand them, indicate that government securities are indeed "securities" within the meaning of section 20. Consequently, it appears to us that the applications approved today, as a matter of law, involve affiliations of member banks with corporations that are in fact not only "principally engaged" in dealing and underwriting in securities, but in fact would be

1 We have joined earlier decisions of the Board authorizing some of these activities in non-securities affiliates.

wholly engaged in such activities, thereby exceeding the authority of law.[2]

Our point is not merely one of legal formalisms. The interpretation adopted by the majority would appear to make feasible, as a matter of law if not Board policy, the affiliations of banks with some of the principal underwriting firms or investment houses of the country. Such a legal result, we feel, is inconsistent with the intent of Congress in passing the Glass-Steagall Act.

As the Board as a whole has repeatedly urged, the plain and desirable remedy to this legal and substantive morass is a fresh Congressional mandate. We urge the Congress to provide straightforwardly the authority for bank holding companies to conduct, with appropriate safeguards, the kinds of activities permitted by the Board in its decision, the practical import of which is confined to a relative handful of large bank holding companies with substantial government securities operations.

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2 Without elaborating on the legal debate reviewed in the Board's order, we wish to reiterate that we fully support earlier Board decisions allowing the underwriting and dealing of government securities to take place in an affiliate. Our point of disagreement is whether that authority can, in effect, be used to bootstrap securities activities that Congress clearly wished to restrain or prohibit.

Appendix A

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Appendix B

The Board issues the following statement setting forth in more detail its findings and analysis underlying certain of the Board's conclusions in its Order of April 30, 1987, regarding the applications of Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation, to engage in limited underwriting and dealing in certain securities proposed in the applications through wholly owned subsidiaries. The Appendix will address the Board's conclusion that the term "public sale" contained in section 20 of the Glass-Steagall Act covers dealing in securities. Section 20 provides that no member of the Federal Reserve System shall be affiliated with any corporation engaged principally in the "issue, flotation, underwriting, public sale, or distribution" of securities. 12 U.S.C. § 377.

The Board concludes that the term "public sale," as used in section 20 of the Glass-Steagall Act, covers the proposed dealing activities. The Board believes this result is consistent with the terms of section 20, the legislative history, the rationale of the Supreme Court's decision in *Securities Industry Association* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 207 (1984) ("*Schwab*"), the Board's long-held view that dealing is covered by the term "public sale" in section 32 of the Glass-Steagall Act—a companion provision to section 20, and Congressional purposes underlying section 20.

In reaching this conclusion the Board has carefully considered the arguments of the Applicants, who contend that "dealing" is not covered by the terms "issue, flotation, underwriting, public sale, or distribution" as used in section 20. In support of this contention, the arguments are advanced that the term "public sale" should be read to refer to underwriting or initial distribution activity because other terms used in section 20 refer to underwriting or initial distributions of securities, that the word "public" used in public sale carries the connotation of a distribution, and that the legislative history would support a distinction between dealing and distributing.

Literally, the term "public sale" in section 20 is broad enough to encompass dealing in securities. In common industry usage, a "dealer" in securities "holds himself out as one engaged in buying and selling securities at a regular place of business"[1] and "sells securities to his customer which he has purchased or intends to purchase elsewhere or buys securities from his customer with a view to disposing of them elsewhere."[2] Thus, a dealer, acting for his own account, maintains an inventory of particular issues of securities in the secondary market—frequently acting as a market maker in these securities.

The term "sale", used in a commercial context, has been interpreted as referring to transactions in which a seller acting as principal transfers title to a buyer.[3] In the Board's view, since a dealer holds himself out to the public as being willing to buy and sell securities for his own account, the dealer can reasonably be viewed as engaging in the "public sale" of particular securities.

The legislative history indicates that Congress intended dealing in securities to be covered by section 20, the provision designed to require member banks to divorce their securities affiliates. In its 1933 report following hearings on the Glass bill, the Senate Banking Committee stated that it proposed to separate member banks from affiliates that devoted themselves not only to underwriting but also to "stock speculation" and

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1 2 L. Loss. *Securities Regulation* 1297 (2d ed. 1961).

2 SEC. *Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Dealer and Broker* xiv-xvi (1936); reprinted in 2 L. Loss. *id.* at 1215-17.

3 *See Webster's Third New International Dictionary* (1961); *Black's Law Dictionary* 1200 (5th ed. 1979); U.C.C. § 2-106 (1978); *see also Gross* v. *Vogel* 81 A.D.2d 576, 437 N.Y.S.2d 431 (1981), and *E.F. Hutton* v. *Zaferson*, 509 S.W.2d 950, 952 (Texas 1974).

"maintaining a market for the banks' own stock."[4] Senator Glass was particularly critical of bank affiliates that "*dealt* in the stocks of the parent bank." 75 Cong. Rec. 9887 (1932) (emphasis added). In describing the activity of a bank securities affiliate to be divorced under the Act, Senator Walcott specifically noted that its business was to underwrite, purchase or sell various securities as they come along in the market.[5]

In *Schwab*, the Supreme Court interpreted the term "public sale" in section 20 as not applying to a discount broker that buys and sells securities solely upon the unsolicited order of customers and not for its own account (as contrasted with a securities dealer, which takes a position in securities). Among other things, the Court stated that "public sale" should be interpreted by reference to the activities described by the terms surrounding it in section 20—the "issue," "flotation," "underwriting," and "distribution" of securities.[6]

Reference to the other activities listed along with "public sale" in section 20, such as "underwriting," supports the Board's view that dealing activities are covered by that statute. As the Court in *Schwab* recognized, in the typical underwriting transaction the underwriter purchases securities from an issuer and resells them to the public and thus, like a dealer, normally acts as a principal in the transaction.[7] Like an underwriter, a

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4 S. Rep. No. 77, 73d Cong., 1st Sess. 10 (1933). Members of Congress criticized the association of banks with the "speculative business of dealing in securities" (75 Cong. Rec. 9904 (1932) (statement of Sen. Walcott)) and banks' establishment of departments that not only began "to engage in the origination, underwriting, and distribution" of investment securities, but also "to trade in them" (75 Cong. Rec. 9911 (1932) (statement of Sen. Bulkley)).

5 75 Cong. Rec. 9905 (1932). See also 75 Cong. Rec. 9912 (1932) (statement of Sen. Bulkley) ("Obviously, the banker who has nothing to sell his depositors is much better qualified to advise disinterestedly" than is the banker who is to receive "an underwriting profit . . . *or a trading profit*") (emphasis added).

6 468 U.S. at 218.

7 *Id.* at 217-18 & n.17.

dealer in securities "buys and sells securities on its own account thereby assuming all risk of loss."[8] Indeed, the Court in *Schwab* stated that section 20 would prohibit a bank affiliate from "dealing in" securities for its own account.[9]

The Board's view that dealing in securities is covered by the language in section 20 is further supported by the Board's long-standing and consistent interpretation that dealing is covered by the related language of section 32 of the Glass-Steagall Act (12 U.S.C. § 78). Section 32 prohibits interlocking officer, director or employee relationships between a member bank and any entity "primarily engaged" in the issue, flotation, underwriting, public sale or distribution of securities. For example, in 1934, the year that the Glass-Steagall Act became effective, the Board ruled that "it is the purpose of section 32 to restrict relationships between member banks and organizations which are directly interested in issues of securities through underwriting, distributing, or *dealing* in such issues."[10] Similarly, in 1965, the Board stated that ". . . acting as a dealer, or generally speak-

8 *Id.* at 218 n. 18.

9 *Id.* at 219 n.20. The Board notes that the heading given section 20 in its codification in title 12 of the United States Code indicates that the statute applies to affiliation with "an organization dealing in securities." 12 U.S.C. § 377 (1934). The heading for section 20 in a compilation of national banking laws published under the direction of the Comptroller of the Currency shortly after section 20 was enacted was "Relationships between Member Banks and Securities Dealers." *The National Bank Act as Amended and Other Laws Relating to National Banks* (U.S. Government Printing Office, July 1, 1933).

10 20 Federal Reserve Bulletin 393 (1934) (emphasis added). *Accord*, 20 Federal Reserve Bulletin 750 (1934), where the Board interpreted section 32 to apply to the manager of a branch of a *dealer* in securities. As originally enacted, section 32 prohibited an interlock with a firm engaged "primarily in the business of purchasing, selling or negotiating securities." 48 Stat. 194. While an amendment to the statute in 1935 changed this provision to conform to the other provisions of the Act (49 Stat. 709), the amendment was not intended to change the scope of coverage of section 32. *See* H.R. Rep. No. 742, 74th Cong., 1st Sess. 17 (1935).

ing, selling or distributing securities as a principal, is covered by [the language of section 32].''[11] In its *Schwab* decision, the Supreme Court expressly stated that, because sections 32 and 20 are complementary provisions of the Glass-Steagall Act, contain identical language and were enacted for similar purposes, long-accepted Board interpretations of section 32 ''should apply as well to § 20.''[12]

Finally, interpreting ''public sale'' to include securities dealing activities is consistent with the basic purposes of the Glass-Steagall Act. Since a dealer operates for its own account in particular securities, *i.e.*, with its own funds, the dealer is subject to the ''inherent risks of the securities business'' and to the ''more subtle hazards'' that arise when a banking organization has a pecuniary interest in the purchase and sale of particular securities.[13] In *Schwab*, the Supreme Court stated that ''[a]ll these 'subtle hazards' are attributable to the promotional pressures that arise from affiliation with entities that purchase and sell particular investments on their own account.'' 468 U.S. at 220 n.23.

The hazards and abuses presented by the business of trading in securities for one's own account are not limited to the distribution of securities but may also arise in the context of secondary market trading where the activities are conducted on a principal basis.[14] For example, a bank might be tempted to promote to its customers the sale of securities held in an affiliate's

11 51 FEDERAL RESERVE BULLETIN 810 (1965); 12 C.F.R. § 218.110. The fact that these Board interpretations were issued prior to the Supreme Court's *Schwab* decision is not persuasive. As noted above, the Supreme Court in *Schwab* stated, consistent with the Board's interpretation, that section 20 prohibits a bank affiliate from dealing in securities. 468 U.S. at 219 n.20.

12 468 U.S. at 219.

13 *Securities Industry Ass'n* v. *Board of Governors of the Federal Reserve System*, 468 U.S. 137, 145 (1984); *Schwab*, 468 U.S. at 220.

14 *See Investment Company Institute* v. *Camp*, 401 U.S. 617, 629-34 (1971).

dealer inventory, particularly when the affiliate is a market maker in particular securities. There may also be the temptation for the bank to make loans to customers in order to facilitate the purchase of securities dealt in by an affiliate or to extend credit or other aid to the affiliate when it is faring badly due to losses from dealing operations.

Moreover, the fact that section 16 of the Glass-Steagall Act (12 U.S.C. § 24 Seventh) expressly prohibits banks from engaging in general securities dealing activities suggests that this function is the kind of activity Congress viewed as giving rise to unwarranted risks and hazards when conducted by a banking organization.

APPENDIX C

The Chase Manhattan Corporation
New York, New York

Order Conditionally Approving Application to Underwrite and Deal in Certain Securities to a Limited Extent

The Chase Manhattan Corporation, New York, New York, a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage through a wholly owned subsidiary, Chase Manhattan Securities, Inc. ("Company"),[1] in underwriting and dealing in, on a limited basis, the following securities:

(1) municipal revenue bonds, including certain industrial development bonds;

(2) residential mortgage-related securities; and

(3) consumer-receivable-related securities ("CRRs").[2]

In addition, Applicant has applied for approval under section 4(c)(8) of the BHC Act for Company to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24 Seventh) (hereinafter "eligible securities"). Company would engage in the proposed under-

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1 Company is presently operating as Chase Manhattan Treasury Corporation.

2 Applicant proposes to limit Company's underwiting and dealing activity in the securities to 10 percent of the total business of the underwriting subsidiary as measured by dollar volume and assets as well as 3 percent of the market.

writing and dealing activities through offices in New York, California, Illinois, Massachusetts, Pennsylvania, and Texas.[3]

Applicant, with consolidated assets of $94.8 billion,[4] is the third largest banking organization in the nation. It operates seven subsidiary banks in New York, Maryland, Ohio, Delaware, Florida, and Arizona and engages in a broad range of permissible nonbanking activities in the United States and abroad.

Notice of the application, affording interested persons an opportunity to submit comments on the proposal, has been published (52 *Federal Register*, 1,380 (1987)). The Board received two comments on the proposal. The Securities Industry Association ("SIA"), a trade association of the investment banking industry, opposes the application for the reasons stated in its earlier protests to similar applications by Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation. The Dealer Bank Association commented in favor of the application.

The Board has previously determined that underwriting and dealing in eligible securities is closely related to banking under section 4(c)(8) of the BHC Act. 12 C.F.R. § 225.25(b)(16). In addition, the Board concludes that Company's performance of this activity may reasonably be expected to result in public benefits which would outweigh adverse effects under the proper incident to banking standard of section 4(c)(8) of the BHC Act. Accordingly, Applicant may engage through Company in underwriting and dealing in eligible securities to the extent that state member banks are authorized by section 16 of the Glass-Steagall Act.

On April 30, the Board approved applications by Citicorp, J.P. Morgan and Bankers Trust to underwrite and deal in, through their eligible securities underwriting subsidiaries, 1-4

3 The Board has previously authorized Applicant to underwrite and deal in third party commercial paper through a commercial finance subsidiary, Chase Commercial Corporation, Englewood, New Jersey, subject to 5 percent gross revenues and market limitations. *The Chase Manhattan Corporation*, 73 FEDERAL RESERVE BULLETIN 367 (1987).

4 Banking data are as of December 31, 1986.

family mortgage-backed securities, municipal revenue bonds (and certain industrial development bonds) and (except for Citicorp) commercial paper.[5] The Board concluded that the underwriting subsidiaries would not be "engaged principally" in undewriting or dealing in securities within the meaning of section 20 of the Glass-Steagall Act[6] provided they derived no more than 5 percent of their total gross revenues from underwriting and dealing in the approved securities over any two-year period and their underwriting and dealing activities did not exceed 5 percent of the market for each particular type of securities involved. The Board further found that, subject to the prudential framework of limitations established in those cases to address the potential for conflicts of interest, unsound banking practices or other adverse effects, the proposed underwriting and dealing activities were so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act. In the case of CRRs, the Board concluded that the record then before it did not provide a sufficient evidentiary basis for it to make the formal finding required by the BHC Act, but stated that it would reconsider the matter within 60 days of its Order on the basis of fuller submissions.

For the reasons set forth in the Board's *Citicorp/Morgan/Bankers Trust* Order, the Board concludes that Applicant's proposal to engage through Company in underwriting and dealing in municipal revenue bonds[7] and 1-4 family mortgage-

5 *Citicorp/Morgan/Bankers Trust, supra.*

6 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of a member bank with "any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."

7 The industrial development bonds approved in those applications and for Applicant in this case are only those tax exempt bonds in which the government issuer, or the governmental unit on behalf of which the bonds are issued, is the owner for federal income tax purposes of the financed facility (such as airports, mass commuting facilities, and water pollution control facilities). Without further approval from the Board, Company may underwrite or deal in only these types of industrial development bonds.

related securities would not result in a violation of section 20 of the Glass-Steagall Act and is closely related and a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act provided Applicant limits Company's activities as provided in the *Citicorp/Morgan/Bankers Trust* Order. The Board will reconsider the permissibility of Applicant's proposal with respect to CRRs within 60 days. Accordingly, the Board has determined to approve the underwriting application subject to all of the terms and conditions established in the *Citicorp/Morgan/Bankers Trust* Order. The Board hereby adopts and incorporates herein by reference the reasoning and analysis contained in the *Citicorp/Morgan/Bankers Trust* Order.

The Board's approval of this application extends only to activities conducted within the limitations of section 225.25(b)(16) of the Board's Regulation Y and the *Citicorp/Morgan/Bankers Trust* Order, including the Board's reservation of authority to establish additional limitations to ensure that the subsidiary's activities are consistent with safety and soundness, conflict of interest and other relevant considerations under the BHC Act. Underwriting and dealing in the approved securities in any manner other than as approved in that Order[8] is not within the scope of the Board's approval and is not authorized for Company.

As the Board noted in the *Citicorp/Morgan/Bankers Trust* Order, Congress has under consideration legislation that would prohibit Board approval of an underwriting application, such as this, between March 6, 1987 and March 1, 1988. While this moratorium legislation has not yet been enacted into law, the Board calls to Applicant's attention that it may be required by subsequent Congressional action to cease its underwriting and dealing activities approved in this Order. The Board retains jurisdiction over the application to act to carry out the requirements of any legislation adopted by Congress that would affect

8 Company may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

Applicant's conduct of underwriting and dealing activities under this Order and the BHC Act.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder.

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of New York, pursuant to delegated authority.

By order of the Board of Governors, effective May 18, 1987.

Voting for this action: Governors Johnson, Seger, and Heller. Voting against this action: Chairman Volcker and Governor Angell.

James McAfee
Associate Secretary of the Board

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

For the reasons set forth in our dissenting statement in the *Citicorp/Morgan/Bankers Trust* Order, we regret we are unable to join the majority in approving this application.

May 18, 1987

APPENDIX D

Chemical New York Corporation
New York, New York

Order Conditionally Approving Applications to Underwrite and Deal in Certain Securities to a Limited Extent and to Place Commercial Paper

Chemical New York Corporation, New York, New York, a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage through a wholly owned subsidiary, Chemical Securities, Inc. ("Company"), in underwriting and dealing in, on a limited basis, the following securities:

(1) municipal revenue bonds, including certain industrial development bonds;

(2) residential mortgage-related securities;

(3) consumer-receivable-related securities ("CRRs"); and

(4) commercial paper.[1]

Applicant has also applied separately for Company to act as agent for issuers of commercial paper and other short-term promissory notes in connection with the placement of such notes with institutional customers.

Applicant has previously received approval under section 4(c)(8) of the BHC Act for Company to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24 Seventh) (hereinafter "eligible

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1 Applicant proposes to limit Company's underwriting and dealing activity in these securities in the same manner and to the same extent as proposed by Bankers Trust in its application to underwrite and deal in these securities. See *Citicorp/J.P. Morgan & Co. Incorporated/ Bankers Trust New York Corporation*, Order dated April 30, 1987, pp. 17-18 n.11.

securities").[2] The proposed new underwriting and dealing activities would be provided in addition to the previously approved activities, with Company serving customers through offices in New York.

Applicant, with total consolidated assets of $60.6 billion, is the seventh largest commercial banking organization in the nation.[3] It operates 69 subsidiary banks in New York, Delaware, Colorado, Florida, and Texas and engages directly and through subsidiaries in a broad range of permissible nonbanking activities.

Notice of the applications, affording interested persons an opportunity to submit comments on the proposals, has been published (51 Federal Register 42,003 and 42,300 (1986)). The Board received two comments on each proposal. The Securities Industry Association ("SIA"), a trade association of the investment banking industry, opposes the applications for the reasons stated in its earlier protests to similar applications by Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation. The Dealer Bank Association commented in favor of the applications.

On April 30, the Board approved applications by Citicorp, J.P. Morgan and Bankers Trust to underwrite and deal in, through their eligible securities underwriting subsidiaries, 1-4 family mortgage-backed securities, municipal revenue bonds (and certain industrial development bonds) and (except for Citicorp) commercial paper.[4] The Board concluded that the underwriting subsidiaries would not be "engaged principally" in underwriting or dealing in securities within the meaning of section 20 of the Glass-Steagall Act[5] provided they derived no

2 These activities are authorized for bank holding companies under section 225.25(b)(16) of Regulation Y. 12 C.F.R. § 225.25(b)(16).

3 Banking data are as of December 31, 1986.

4 *Citicorp/Morgan/Bankers Trust, supra.*

5 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of a member bank with "any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."

more than 5 percent of their total gross revenues from underwriting and dealing in the approved securities over any two year period and their underwriting and dealing activities did not exceed 5 percent of the market for each particular type of security involved. The Board further found that, subject to the prudential framework of limitations established in those cases to address the potential for conflicts of interest, unsound banking practices or other adverse effects, the proposed underwriting and dealing activities were so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act. In the case of CRRs, the Board concluded that the record then before it did not provide a sufficient evidentiary basis for it to make the formal finding required by the BHC Act, but stated it would reconsider the matter within 60 days of its Order on the basis of fuller submissions.

For the reasons set forth in the Board's *Citicorp/Morgan/Bankers Trust* Order, the Board concludes that Applicant's proposal for Company to underwrite and deal in municipal revenue bonds,[6] commercial paper and 1-4 family mortgage-related securities would not result in a violation of section 20 of the Glass-Steagall Act and is closely rated and a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act, provided Applicant limits Company's activities as provided in the *Citicorp/Morgan/Bankers Trust* Order. The Board will reconsider the permissibility of Applicant's proposal with respect to CRRs within 60 days. Accordingly, the Board has determined to approve the underwriting application subject to all of the terms and conditions established in the *Citicorp/Morgan/Bankers Trust* Order. The Board hereby adopts and incorporates herein by reference the reasoning and analysis contained in the *Citicorp/Morgan/Bankers Trust* Order.

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6 The industrial development bonds approved in these applications and for Applicant in this case are only those tax exempt bonds in which the governmental issuer, or the governmental unit on behalf of which the bonds are issued, is the owner for federal income tax purposes of the financed facility (such as airports, mass commuting facilities, and water pollution control facilities). Without further approval from the Board, Company may underwrite or deal in only these types of industrial development bonds.

For the reasons set forth in the Board's *Bankers Trust* commercial paper placement decision,[7] the Board concludes that Applicant's proposal to place commercial paper is also consistent with section 20 of the Glass-Steagall Act and permissible for bank holding companies under section 4(c)(8) of the BHC Act, subject to the prudential limitations of that Order and the *Citicorp/Morgan/Bankers Trust* Order.

The Board's approval of these applications extends only to activities conducted within the limitations of the *Citicorp/Morgan/Bankers Trust* Order and the *Bankers Trust* commercial paper placement Order, including the Board's reservation of authority to establish additional limitations to ensure that the subsidiary's activities are consistent with safety and soundness, conflict of interest and other relevant considerations under the BHC Act. Underwriting and dealing in the approved securities, or acting as agent for the placement of commercial paper, in any manner other than as approved in those Orders[8] is not within the scope of the Board's approval and is not authorized for Company.

As the Board noted in the *Citicorp/Morgan/Bankers Trust* Order, Congress has under consideration legislation that would prohibit Board approval of an underwriting application, such as this, between March 6, 1987 and March 1, 1988. While this moratorium legislation has not yet been enacted into law, the Board calls to Applicant's attention that it may be required by subsequent Congressional action to cease its underwriting and

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7 *Bankers Trust New York Corporation*, 73 FEDERAL RESERVE BULLETIN 138 (1987). Company may underwrite, deal in and place only commercial paper that is exempt from the registration and prospectus requirements of the Securities Act of 1933 and that is short term, of prime quality, and issued in denominations no smaller than $100,000. Applicant has stated the paper will be issued or backed by large companies and sold to financially sophisticated corporate and other institutional investors.

8 Company may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

dealing activities approved in this Order. The Board retains jurisdiction over the applications to act to carry out the requirements of any legislation adopted by Congress that would affect Applicant's conduct of underwriting and dealing activities under this Order and the BHC Act.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder.

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of New York, pursuant to delegated authority.

By order of the Board of Governors, effective May 18, 1987.

Voting for this action: Governors Johnson, Seger, and Heller. Voting against this action: Chairman Volcker and Governor Angell.

James McAfee
Associate Secretary of the Board

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

For the reasons set forth in our dissenting statement in the *Citicorp/Morgan/Bankers Trust* Order, we regret we are unable to join the majority in approving this application.

May 18, 1987

APPENDIX E

Citicorp
New York, New York

Order Approving Application to Underwrite and Deal in Commercial Paper to a Limited Extent

Citicorp, New York, New York, a bank holding company within the meaning of the Bank Holding Company Act, 12 U.S.C. § 1841 *et seq.* ("BHC Act"), has applied pursuant to section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)) and section 225.21(a) of the Board's Regulation Y (12 C.F.R. § 225.21(a)) to engage through Citicorp Securities, Inc. ("CSI"), a wholly owned subsidiary, in underwriting and dealing in commercial paper to a limited extent.[1]

Applicant has previously received Board approval for CSI to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24 Seventh) (hereinafter "eligible securities").[2] On April 30, 1987, the Board authorized Citicorp to engage through CSI in underwriting and dealing in 1-4 family mortgage-backed securities and municipal revenue bonds.[3]

Citicorp, with total consolidated assets of $196 billion, is the largest banking organization in the nation.[4] It operates eight banking subsidiaries and engages directly and through subsidiaries in a broad range of permissible nonbanking activities.

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1 Applicant proposes to limit CSI's underwriting and dealing activity in commercial paper as described in its application to underwrite and deal in municipal revenue bonds, mortgage-backed securities and consumer-receivable-related securities. *See Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation* ("*Citicorp/Morgan/Bankers Trust*"), Order dated April 30, 1987, pp. 17-18 n.11.

2 These activities are authorized for bank holding companies under section 225.25(b)(16) of Regulation Y. 12 C.F.R. § 225.25(b)(16).

3 *Citicorp/Morgan/Bankers Trust, supra.*

4 All asset data are as of December 31, 1986.

Notice of the application, affording interested persons an opportunity to submit comments on the proposal, has been published (52 *Federal Register* 13,317 (1987)). The Securities Industry Association ("SIA"), a trade association of the investment banking industry, opposes the application for the reasons stated in its earlier protests to similar applications by Citicorp, J.P. Morgan and Bankers Trust.

In its *Citicorp/Morgan/Bankers Trust* decision, the Board concluded that CSI and the eligible securities underwriting subsidiaries of J.P. Morgan and Bankers Trust would not be "engaged principally" in underwriting or dealing in municipal revenue bonds, 1-4 family mortgage-backed securities and (except for Citicorp) commercial paper within the meaning of section 20 of the Glass-Steagall Act[5] provided they derived no more than 5 percent of their total gross revenues from underwriting and dealing in the approved securities over any two year period and their underwriting and dealing activities did not exceed 5 percent of the market for each particular type of security involved. The Board further found that, subject to the prudential framework of limitations established in those cases to address the potential for conflicts of interest, unsound banking practices or other adverse effects, the proposed underwriting and dealing activities were so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act.

For the reasons set forth in the *Citicorp/Morgan/Bankers Trust* Order,[6] the Board concludes that Applicant's proposal for CSI to underwrite and deal in commercial paper would not result in a violation of section 20 of the Glass-Steagall Act and

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5 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of a member bank with "any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."

6 In *The Chase Manhattan Corporation*, 73 FEDERAL RESERVE BULLETIN 367 (1987), the Board found that underwriting commercial paper was closely related to banking under section 4(c)(8) of the BHC Act. The *Citicorp/Morgan/Bankers Trust* decision incorporated the findings.

is closely related and a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act provided Applicant limits CSI's activities as provided in the *Citicorp/Morgan/Bankers Trust* Order. Accordingly, the Board has determined to approve the application subject to the terms and conditions established in the *Citicorp/Morgan/Bankers Trust* Order. The Board hereby adopts and incorporates herein by reference the reasoning and analysis contained in the *Citicorp/Morgan/Bankers Trust* and *Chase* Orders.

The Board's approval of this application extends only to activities conducted within the limitations of the *Citicorp/Morgan/Bankers Trust* Order, including the Board's reservation of authority to establish additional limitations to ensure that the subsidiary's activities are consistent with safety and soundness, conflict of interest and other relevant considerations under the BHC Act. Underwriting and dealing in commercial paper in any manner other than as approved in that Order[7] is not within the scope of the Board's approval and is not authorized for CSI.

As the Board noted in the *Citicorp/Morgan/Bankers Trust* Order, Congress has under consideration legislation that would prohibit Board approval of an underwriting application, such as this, between March 6, 1987 and March 1, 1988. While this moratorium legislation has not yet been enacted into law, the Board calls to Applicant's attention that it may be required by subsequent Congressional action to cease its underwriting and dealing activities approved in this Order. The Board retains jurisdiction over the application to act to carry out the requirements of any legislation adopted by Congress that would affect Applicant's conduct of the underwriting and dealing activities under this Order and the BHC Act.

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7 CSI may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder.

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of New York, pursuant to delegated authority.

By order of the Board of Governors, effective May 18, 1987.

Voting for this action: Governors Johnson, Seger, and Heller. Voting against this action: Chairman Volcker and Governor Angell.

Associate Secretary of the Board
James McAfee

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

For the reasons set forth in our dissenting statement in the *Citicorp/Morgan/Bankers Trust* order, we regret we are unable to join the majority in approving this application.

May 18, 1987

APPENDIX F

Manufacturers Hanover Corporation
New York, New York

Order Conditionally Approving Application to Underwrite and Deal in Certain Securities to a Limited Extent and to Place Commercial Paper

Manufacturers Hanover Corporation, New York, New York, a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage through a wholly owned subsidiary, Manufacturers Hanover Securities Corporation ("Company"), in underwriting and dealing in, on a limited basis, the following securities:

(1) municipal revenue bonds, including certain industrial development bonds;

(2) residential mortgage-related securities;

(3) consumer-receivable-related securities ("CRRs"); and

(4) commercial paper.[1]

Applicant has also applied for Company to act as agent for issuers of commercial paper in connection with the placement of such notes with institutional customers.

Applicant has previously received approval under section 4(c)(8) of the BHC Act for Company to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24 Seventh) (hereinafter "eligible

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1 Applicant proposes to limit Company's underwriting and dealing activity in these securities in the same manner and to the same extent as proposed by Bankers Trust in its application to underwrite and deal in these securities. *See Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation*, Order dated April 30, 1987, pp. 17-18 n.11.

securities").[2] In addition, Company, pursuant to Board authorization, engages in securities brokerage services pursuant to section 225.25(b)(15) of Regulation Y, 12 C.F.R. § 225.25-(b)(15). These brokerage services are conducted separately from the eligible securities underwriting and dealing activity. The proposed new underwriting and dealing activities would be provided in addition to the previously approved activities, with Company serving customers through offices in New York.

Applicant, with total consolidated assets of $75.8 billion, is the fifth largest commercial banking organization in the nation.[3] It operates two subsidiary banks in New York and Delaware and engages directly and through subsidiaries in a broad range of permissible nonbanking activities.

Notice of the application, affording interested persons an opportunity to submit comments on the proposal, has been published (52 *Federal Register* 6,218 (1987)). The Board received two comments on the proposal. The Securities Industry Association ("SIA"), a trade association of the investment banking industry, opposes the application for the reasons stated in its earlier protests to similar applications by Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation. The Dealer Bank Association commented in favor of the application.

On April 30, the Board approved applications by Citicorp, J.P. Morgan and Bankers Trust to underwrite and deal in, through their eligible securities underwriting subsidiaries, 1-4 family mortgage-backed securities, municipal revenue bonds (and certain industrial development bonds) and (except for Citicorp) commercial paper.[4] The Board concluded that the underwriting subsidiaries would not be "engaged principally" in underwriting or dealing in securities within the meaning of sec-

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2 These activities are authorized for bank holding companies under section 225.25(b)(16) of Regulation Y. 12 C.F.R. § 225.25(b)(16).

3 Asset data are as of March 31, 1987. Banking data are as of December 31, 1986.

4 *Citicorp/Morgan/Bankers Trust, supra.*

tion 20 of the Glass-Steagall Act[5] provided they derived no more than 5 percent of their total gross revenues from underwriting and dealing in the approved securities over any two year period and their underwriting and dealing activities did not exceed 5 percent of the market for each particular type of security involved. The Board further found that, subject to the prudential framework of limitations established in those cases to address the potential for conflicts of interest, unsound banking practices or other adverse effects, the proposed underwriting and dealing activities were so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act. In the case of CRRs, the Board concluded that the record then before it did not provide a sufficient evidentiary basis for it to make the formal finding required by the BHC Act, but stated that it would reconsider the matter within 60 days of its Order on the basis of fuller submissions.

For the reasons set forth in the Board's *Citicorp/Morgan/Bankers Trust* Order, the Board concludes that Applicant's proposal to engage through Company in underwriting and dealing in municipal revenue bonds,[6] commercial paper and 1-4 family mortgage-related securities would not result in a violation of section 20 of the Glass-Steagall Act and is closely related and a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act provided Applicant limits Company's activities as provided in the *Citicorp/Morgan/Bankers Trust* Order. The Board will reconsider the permissibility of Appli-

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5 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of a member bank with "any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."

6 The industrial development bonds approved in those applications and for Applicant in this case are only those tax exempt bonds in which the governmental issuer, or the governmental unit on behalf of which the bonds are issued, is the owner for federal income tax purposes of the financed facility (such as airports, mass commuting facilities, and water pollution control facilities). Without further approval from the Board, Company may underwrite or deal in only these types of industrial development bonds.

cant's proposal with respect to CRRs within 60 days. Accordingly, the Board has determined to approve the underwriting application subject to the terms and conditions established in the *Citicorp/Morgan/Bankers Trust* Order. The Board hereby adopts and incorporates herein by reference the reasoning and analysis contained in the *Citicorp/Morgan/Bankers Trust* Order.

For the reasons set forth in the Board's Order in *Bankers Trust* approving commercial paper placement activity, the Board concludes that Applicant's proposal to place commercial paper is also consistent with section 20 of the Glass-Steagall Act and permissible for bank holding companies under section 4(c)(8) of the BHC Act, subject to the prudential limitations of that Order and the *Citicorp/Morgan/Bankers Trust* Order.[7]

The Board's approval of this application extends only to activities conducted within the limitations of the *Citicorp/Morgan/Bankers Trust* Order and the *Bankers Trust* commercial paper placement Order, including the Board's reservation of authority to establish additional limitations to ensure that the subsidiary's activities are consistent with safety and soundness, conflict of interest and other relevant considerations under the BHC Act. Underwriting and dealing in the approved securities in any manner other than as approved in those Orders[8] is not within the scope of the Board's approval and is not authorized for Company.

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7 *Bankers Trust New York Corporation*, 73 FEDERAL RESERVE BULLETIN 138 (1987). Company may underwrite, deal in and place only commercial paper that is exempt from the registration and prospectus requirements of the Securities Act of 1933 and that is short term, of prime quality, and issued in denominations no smaller than $100,000. Applicant has stated the paper will be issued or backed by large companies and sold to financially sophisticated corporate and other institutional investors.

8 Company may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

As the Board noted in the *Citicorp/Morgan/Bankers Trust* Order, Congress has under consideration legislation that would prohibit Board approval of an underwriting application, such as this, between March 6, 1987 and March 1, 1988. While this moratorium legislation has not yet been enacted into law, the Board calls to Applicant's attention that it may be required by subsequent Congressional action to cease its underwriting and dealing activities approved in this Order. The Board retains jurisdiction over the application to act to carry out the requirements of any legislation adopted by Congress that would affect Applicant's conduct of underwriting and dealing activities under this Order and the BHC Act.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder.

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of New York, pursuant to delegated authority.

By order of the Board of Governors, effective May 18, 1987.

Voting for this action: Governors Johnson, Seger, and Heller. Voting against this action: Chairman Volcker and Governor Angell.

James McAfee
Associate Secretary of the Board

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

For the reasons set forth in our dissenting statement in the *Citicorp/Morgan/Bankers Trust* Order, we regret we are unable to join the majority in approving this application.

May 18, 1987

APPENDIX G

Security Pacific Corporation
Los Angeles, California

Order Conditionally Approving Application to Underwrite and Deal in Certain Securities to a Limited Extent

Security Pacific Corporation, Los Angeles, California, a bank holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y, 12 C.F.R. § 225.21(a), to engage through a wholly owned subsidiary, Security Pacific Securities, Inc. ("Company"), in underwriting and dealing in, on a limited basis, the following securities:

(1) municipal revenue bonds, including certain industrial development bonds;

(2) residential mortgage-related securities;

(3) consumer-receivable-related securities ("CRRs"); and

(4) commercial paper.[1]

Applicant has previously received approval under section 4(c)(8) of the BHC Act for Company to underwrite and deal in U.S. government and agency and state and municipal securities that state member banks are authorized to underwrite and deal in under section 16 of the Banking Act of 1933 (the "Glass-Steagall Act") (12 U.S.C. § 24 Seventh) (hereinafter "eligible securities").[2] The proposed new underwriting and dealing activities would be provided in addition to the previously ap-

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1 Applicant proposes to limit Company's underwriting and dealing activity in these securities in the same manner and to the same extent as proposed by Bankers Trust in its application to underwrite and deal in these securities. *See Citicorp, J.P. Morgan & Co. Incorporated and Bankers Trust New York Corporation*, Order dated April 30, 1987, pp. 17-18 n.11.

2 These activities are authorized for bank holding companies under section 225.25(b)(16) of Regulation Y. 12 C.F.R. § 225.25(b)(16).

proved eligible securities activities, with Company serving customers through offices in Los Angeles.

Applicant, with total consolidated assets of $64.0 billion, is the sixth largest commercial banking organization in the nation.[3] It operates five subsidiary banks in California, Arizona, Washington and Oregon and engages directly and through subsidiaries in a broad range of permissible nonbanking activities.

Notice of the application, affording interested persons an opportunity to submit comments on the proposal, has been published (52 *Federal Register* 8,365 (1987)). The Board received two comments on the proposal. The Securities Industry Association ("SIA"), a trade association of the investment banking industry, opposes the application for the reasons stated in its earlier protests to similar applications by Citicorp, *J.P. Morgan & Co. Incorporated* and *Bankers Trust New York Corporation*. The Dealer Bank Association commented in favor of the application.

On April 30, the Board approved applications by Citicorp, J.P. Morgan and Bankers Trust to underwrite and deal in, through their eligible securities underwriting subsidiaries, 1-4 family mortgage-backed securities, municipal revenue bonds (including certain industrial development bonds) and (except for Citicorp) commercial paper.[4] The Board concluded that the underwriting subsidiaries would not be "engaged principally" in underwriting or dealing in securities within the meaning of section 20 of the Glass-Steagall Act[5] provided they derived no more than 5 percent of their total gross revenues from underwriting and dealing in the approved securities over any two year period and their underwriting and dealing activities did not exceed 5 percent of the market for each particular type of security

3 Asset data are as of March 31, 1987. Banking data are as of December 31, 1986.

4 *Citicorp/Morgan/Bankers Trust, supra.*

5 Section 20 of the Glass-Steagall Act (12 U.S.C. § 377) prohibits the affiliation of a member bank with "any corporation . . . engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities. . . ."

involved. The Board further found that, subject to the prudential framework of limitations established in those cases to address the potential for conflicts of interest, unsound banking practices or other adverse effects, the proposed underwriting and dealing activities were so closely related to banking as to be a proper incident thereto within the meaning of section 4(c) of the BHC Act. In the case of CRRs, the Board concluded that the record then before it did not provide a sufficient evidentiary basis for it to make the formal findings required by the BHC Act, but stated that it would reconsider the matter within 60 days of its Order on the basis of fuller submissions.

For the reasons set forth in the Board's *Citicorp/Morgan/Bankers Trust* Order, the Board concludes that Applicant's proposal to engage through Company in underwriting and dealing in municipal revenue bonds,[6] commercial paper and 1-4 family mortgage-related securities would not result in a violation of section 20 of the Glass-Steagall Act and is closely related and a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act provided Applicant limits Company's activities as provided in the *Citicorp/Morgan/Bankers Trust* Order. The Board will reconsider the permissibility of Applicant's proposal with respect to CRRs within 60 days. Accordingly, the Board has determined to approve the underwriting application subject to the terms and conditions established in the *Citicorp/Morgan/Bankers Trust* Order. The Board hereby adopts and incorporates herein by reference the reasoning and analysis contained in the *Citicorp/Morgan/Bankers Trust* Order.

The Board's approval of this application extends only to activities conducted within the limitations of the *Citicorp/Morgan/Bankers Trust* Order, including the Board's reserva-

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6 The industrial development bonds approved in those applications and for Applicant in this case are only those tax exempt bonds in which the governmental issuer, or the governmental unit on behalf of which the bonds are issued, is the owner for federal income tax purposes of the financed facility (such as airports, mass commuting facilities, and water pollution control facilities). Without further approval from the Board, Company may underwrite or deal in only these types of industrial development bonds.

tion of authority to establish additional limitations to ensure that the subsidiary's activities are conducted consistent with safety and soundness, conflict of interest and other relevant considerations under the BHC Act. Underwriting and dealing in the approved securities in any manner other than as approved in that Order[7] is not within the scope of the Board's approval and is not authorized for Company.

As the Board noted in the *Citicorp/Morgan/Bankers Trust* Order, Congress has under consideration legislation that would prohibit Board approval of an underwriting application, such as this, between March 6, 1987 and March 1, 1988. While this moratorium legislation has not yet been enacted into law, the Board calls to Applicant's attention that it may be required by subsequent Congressional action to cease its underwriting and dealing activities approved in this Order. The Board retains jurisdiction over the application to act to carry out the requirements of any legislation adopted by Congress that would affect Applicant's conduct of underwriting and dealing activities under this Order and the BHC Act.

The Board's determination is subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with, and to prevent evasion of, the provisions of the BHC Act and the Board's regulations and orders issued thereunder.

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7 Company may also provide services that are necessary incidents to these approved activities. The incidental services should be taken into account in computing the gross revenue and market share limits on the underwriting subsidiaries' ineligible underwriting and dealing activities, to the extent such limits apply to particular incidental activities.

Applicant has proposed to place third party commercial paper as agent as an incident to its commercial paper underwriting and dealing activity. In this case, the Board concludes that Company may, as an incident to its commercial paper underwriting and dealing activities, engage in commercial paper placement provided Company observes the prudential limitations set forth by the Board in the *Citicorp/Morgan/Bankers Trust* Order and *Bankers Trust New York Corporation*, 73 FEDERAL RESERVE BULLETIN 138 (1987).

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of San Francisco, pursuant to delegated authority.

By order of the Board of Governors, effective May 18, 1987.

Voting for this action: Governors Johnson, Seger, and Heller. Voting against this action: Chairman Volcker and Governor Angell.

James McAfee
Associate Secretary of the Board

[SEAL]

Dissenting Statement of Chairman Volcker and Governor Angell

For the reasons set forth in our dissenting statement in the *Citicorp/Morgan/Bankers Trust* Order, we regret we are unable to join the majority in approving this application.

May 18, 1987

APPENDIX H

RELEVANT PROVISIONS OF THE BANKING ACT OF 1933 (THE GLASS-STEAGALL ACT)

SECTION 16:

12 U.S.C. § 24. Corporate Powers of Associations

Upon duly making and filing articles of association and an organization certificate a national banking association shall become, as from the date of the execution of its organization certificate, a body corporate, and as such, and in the name designated in the organization certificate, it shall have power—

* * * *

Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, except that this limitation shall not require any association to dispose of any securities lawfully held by it on August 23, 1935. As used in this section the term "investment securities" shall mean marketable obligations, evidencing indebtedness of any person, co-partnership, association, or corporation in the form of bonds, notes and/or deben-

tures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permitted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof. . . .

SECTION 20:

12 U.S.C. § 377. Affiliation with organization dealing in securities; penalties

After one year from June 16, 1933, no member bank shall be affiliated in any manner described in subsection (b) of section 221a of this title with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities: *Provided*, That nothing in this paragraph shall apply to any such organization which shall have been placed in formal liquidation and which shall transact no business except such as may be incidental to the liquidation of its affairs.

SECTION 21:

12 U.S.C. § 378. Dealers in securities engaging in banking business; individuals or associations engaging in banking business; examinations and reports; penalties

(a) After the expiration of one year after June 16, 1933, it shall be unlawful—

(1) For any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or

retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits subject to check or to repayment upon presentation of a passbook, certificate of deposit, or other evidence of debt, or upon request of the depositor: *Provided*, That the provisions of this paragraph shall not prohibit national banks or State banks or trust companies (whether or not members of the Federal Reserve System) or other financial institutions or private bankers from dealing in, underwriting, purchasing, and selling investment securities, or issuing securities, to the extent permitted to national banking associations by the provisions of section 24 of this title: *Provided further*, That nothing in this paragraph shall be construed as affecting in any way such right as any bank, banking association, savings bank, trust company, or other banking institution, may otherwise possess to sell, without recourse or agreement to repurchase, obligations evidencing loans on real estate;

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SECTION 32:

12 U.S.C. § 78. Certain persons excluded from serving as officers, directors or employees of member banks

No officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank except in limited classes of cases in which the Board of Governors of the Federal Reserve System may allow such service by general regulations when in the judgment of the said Board it would not unduly influence the investment policies of such member bank or the advice it gives its customers regarding investments.